M&A Seminar Series, Session Four

CEO View Summary

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Summary of Discussion Points

Panel

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Buy Side

- **Acquisition vs. Internal Development or Partnering — How do you view which is the right strategy for growth?**

Overview

Evaluating whether to grow by partnering, buying others, or being acquired is an ongoing process that must be revisited often. A company must analyze its alternatives from the viewpoint of assuming that it would remain an independent company. While there may be many products a company can develop on its own if it has the cash to fund internal development and the internal skills to engage in the development effort, there still may be circumstances where it makes sense to look at acquisition or partnering.

The pressure to evaluate the possibility of being acquired intensifies when a company's competitors start being acquired, resulting in consolidation in the company's market segment.

Internal Development

At least as a public company, maintaining your profitability is the KEY to being able to fund your internal development efforts. If a company has cash and is profitable, its Board will be more inclined to let the CEO take on a few R&D investments that might never show a big return. But before you become profitable, the CEO will face more pressure from the Board to only fund R&D with a more certain and near term payoff. So, a lack of profitability can inhibit success in many directions.

Internal development is just not an option in many cases. Companies often overlook the drag of an installed base. If you don't have installed base, like a start up, you have more design and development freedom, which explains why many of the most innovative ideas come from start ups, not the largest players in a market segment. At large companies, engineering management often can't support the idea of going down a development path that creates compatibility and support issues, so they artificially limit the perceived design options.

The key to success in software R&D is having a deeply experienced, high quality R&D team, as they understand how to develop code that really solves the customers' problems. Software development by definition is a fluid process that is often best done by a small, dedicated team, which typically has a few superstars. If a large company does manage to develop a successful product, and then its superstars leave, it is often very difficult for the remaining team members (who are not the superstars), to enhance or even maintain the product. Conversely, in the start up context, the employees are often a group of superstars, and they are highly motivated by the M&A upside, so they can often better turn out the cutting edge technology. So that is why internal development in this context is often not as successful as buying developers of cutting edge technology.

One problem with internal development is that there is no guarantee, once the development effort is completed, that a best of breed product will result. Conversely, if a company has the ability to survey the market and identify which technology is best of breed, it can then go buy that best of breed developer with greatly reduced technology and market risk.

As to comparing internal development with buying companies for their technology, buying companies with individual products makes sense when the products do not need to be integrated, but if the products must be integrated with the buyer's own products, that generally favors internal development over acquisition. If a company does not have the right team and resources to internally develop a product, however, then obviously it must buy a company that has the right development team or license or obtain distribution rights to the products it needs.

Partnering

In many market segments, OEM and other business "partnership" deals have typically not been win-win for both parties. For example, if one large company takes an OEM distribution right to a start up's product, but then the start up is acquired by a competitor of the large company, that can leave the licensee with a terminated license. Similarly, in OEM deals, there are often many differing views as to account control and the optimum path of future development. Another issue is the licensee is often concerned that if it relies too heavily on the licensed product, once the OEM Agreement's term expires, the licensor will have an undue amount of leverage in negotiating renewal terms. OEM deals can also founder because of the channel conflicts they create. Similarly, OEM deals don't work with products that are so technology oriented that they can only be re-sold using an extremely sophisticated sales and AE force, as it is hard for the licensee to justify developing those resources for a technology as to which it has perhaps only temporary distribution rights. Often the licensing party feels that the OEM partner doesn't pay enough attention to upgrading or supporting the licensed product and in any event the licensee feels that it does not control its destiny. For this reason, OEM deals rarely make sense for a key technology in the licensee's area of core competency. OEM deals also create sales compensation issues for the party with the distribution right—if that party's sales force is paid less to sell the licensed product than an internally developed product, the licensed product usually won't receive the same level of sales support as internal products. In sum, as a growth strategy, "partnering" is a nice idea, but it is usually either mostly non-substantive joint marketing agreements, or if substantive, it is just not a mutually beneficial deal for the reasons noted.

M&A

In general, internal development is often best if you have the skills, as it is usually cheaper and faster, so long as the development does not impair your ability to remain profitable; but if internal development takes a considerable time period, maybe it's better (and faster) to buy a company with the relevant capability, to avoid missing a market window. From an acquiror's viewpoint, it is natural to want to buy companies and gain revenue synergies by pushing the target's products through its sales channel, or gain product synergies by augmenting and fleshing out its product line. Acquisitions are often the best way to reliably expand. From the target's viewpoint, at least in some market segments with established dominant players, being acquired can be viewed as relatively inevitable, whether or not a company plans to go public.

From a buy side view, if a third party has technology outside of a company's core area of competence, and the potential buyer does not have the internal skills to develop that technology, and the buyer is really buying a R&D team without a lot of excess G&A cost, buying the target is clearly the best approach. On the other hand, if the target's technology is within the buyer's core competency area, and the target's technology is better than the internal technology of the potential buyer, that's much more difficult, as the buyer is presented with a clear need to kill its internal product, its "R&D team's baby". That is very hard to do emotionally. It take courage for the CEO to admit that the internal development effort was a failure, and it is difficult to avoid insulting the internal R&D team, and to avoid internal resentment between the two R&D teams in this circumstance. It is also difficult to make these product transitions in a crisp and clean way, particularly given legacy support issues with customers. But in hindsight it is often clear that making the hard decision to kill the internal product in favor of the acquired product is the best course.

- **Targeting and Pursuing Opportunities, M&A Philosophy — e.g., Re EPS Dilution, Valuation, Strategic Fit, Cultural Fit, Extent of Product and Employee Overlap**

Startups must have realistic expectations early on as to their ultimate valuation in an M&A exit, as, nine times out of ten, M&A will be the most likely liquidity path. If the target is shooting for too high a valuation at exit, it will raise money that drives liquidation preferences that are so large, they force the company to demand M&A valuations that are unrealistic and/or that have participating preferences that leave little value in the M&A deal for the employee holders of the common stock.

A buyer's CEO should rarely believe the target's revenue projections, unless the target has a lengthy track record.

As to strategic fit, the fit of the target's technology with the buyer's is obviously critical. Just bolting on an extra product won't work, where it is critical for the buyer to deliver an integrated suite of products. Cultural fit is also critical, starting with the ability of the target team itself to work together and get along. But in terms of assuring cooperation between internal and external teams, the key is, if you buy a high quality team, then the respect will be there, and the teams will get along. Of course M&A deals that are accretive and that generate cash to pay for themselves over the short term are ideal, but if a deal is highly strategic, and has a large revenue upside in a key new area, it makes sense to accept dilution over a long period to invest in that upside, even if the buyer is initially penalized by the Street as to the buyers' trading price. A CEO must have the courage to do dilutive deals that offer tremendous upside.

One must be very careful that inquiries from larger companies about potential "partnerships" are not really disguised fishing expeditions that are designed to enable the larger companies to look under covers to decide whether to buy a potential target, or focus their development efforts on competing with the target. The larger companies have a massive advantage in R&D, aided by this intelligence they get in such preliminary discussions, so smaller rivals have to be careful about what they reveal. But as a smaller company, even a public company, you really can't afford to not talk to potential partners/acquirors, despite these risks (and annoyances).

All rules of dating apply to M&A—(i) you can't look too anxious, (ii) you can't be too easy; (iii) you will drive yourself crazy if you wait by the phone, (iv) there's a lot of strategy as to who makes the first call; and (v) dress up, but act like you don't care.

Many CEOs look at the M&A event as the final event, but in fact it's just one more milestone, and nothing is really achieved if the business combination is not successful. So, the target CEO's goal should include helping the acquirer, post closing, to make the deal a financial win-win for the buyer. M&A deals can help build momentum in the target's products, due to the halo effect of being part of a larger company. Post merger target management can defer orders rather than give a discount to close the order in the current quarter. When an acquired company has that flexibility, customers' discounting demands generally abate.

The best M&A deals generally have the following five characteristics, in this order of importance: strategic (long term) fit that leads to building critical mass; product complementarity, cultural fit, geographic fit, and a deal that is a financial win win for both parties (i.e., if either party resents the deal terms, then it won't be a great deal).

Other keys to M&A success are: clarity and speed—the longer you take to get the deal done, and the more ambiguous the communication, the more confusion you create.

Obviously, both parties will come up with their own views as to valuation, based in part on traditional formulas (DCF, comparable companies, and comparative deals analyses), and both will come up with a view as to the revenue synergies the target will bring. What is critical is that both sides converge on a reasonable view as to those revenue synergies and as to what a fair means of sharing those synergies is. What often happens, however, is that the target CEO or Board members do not have the sophistication to understand what is reasonable in this context, and the target insists on realizing all the synergies in the deal value, even though the buyer's channel is often the principal reason for generating those synergies. So the key take away is that both leadership teams have to be mature enough to agree on a fair means of sharing synergies. Perhaps the best way to reach such agreement on valuation is to have a clear understanding of the product roadmap going forward.

A related point is that perhaps the best way to achieve strategic fit is to have an honest and candid exchange of views as to product transition between the buyer and target CEOs. But what often happens instead is that the buyer CEO is not quite as candid or as decisive as he should be, and he does not explain internally that the buyer's own technology will be phased out. In that case, false hopes are created internally, resulting in tension and resentment between the buyer and target R&D and sales teams, which both can lead to customer confusion. The right question in choosing between potential bidders is "Which buyer would do a better job of letting the target's products thrive in the market?"

Obviously, the greater the product overlap, the harder it is to have a successful acquisition, and deals involving 100% overlap are very difficult. However, there are exceptions where deals involving substantial product overlap have worked extremely well, if a smooth transition is made a priority.

Cultural fit is difficult to evaluate. Normally, if you merge two Silicon Valley companies (as opposed to East Coast and West Coast companies), there will not be much of a culture clash, other than the big company/small company differences, but those can be overcome. The buyer always says, "we are an entrepreneurial company, we are still enthusiastic and have a start up culture", but that's usually just not true. Sometimes, a target is put off by the cultural differences observed with one bidder, but that's just because that buyer is being honest, for example, about the need to immediately and fully integrate and subsume the target. In that case, a second bidder may persuade the target of a better fit by "promising " independence, but that is unrealistic, even if sincere, as it is just too hard to keep the sales force of a target independent. In sum, more often than not, there will be, and you should expect there will be, some cultural disconnect.

- **Selling the Deal to Wall Street and the Board**

It is much harder now to convince Boards that M&A deals make sense, especially given SOX concerns and the level of detail that drives. It is critical to keep the Board updated on the deal from day one, and to have one or more Board members help the CEO by advocating for the deal. The key is to persuade the Board why the deal is essential, why you can't do the R&D internally, demonstrate the long term and short term strategic value, demonstrate why the technology is a good fit, and have an integration plan that makes sense. Then it's up to the CEO to achieve the metrics promised to the Board for each M&A deal.

In general, a buyer's stock trades down, not up, when it announces a deal. So a buyer's CEO must focus on the long term, deliver on long term guidance to the street and look to be rewarded over the long term. Build credibility, show traction and interact frequently with the street. However, as CEO, don't listen too much to analysts, as they don't have the same goals, or view, as you.

Typically, it is not hard to sell the target's Board that being acquired makes sense. The outside Board members typically will understand the target's limitations, like the lack of a great distribution channel, and thus the ultimate need to be acquired. For the non-CEO founder of a company that remains on the Board, it is harder to support a decision to sell, because the founder so closely identifies with the company and its perceived success, so the decision is more emotional, but logic usually prevails.

Tips on Board management: (i) work on making sure that your founder is open to alternatives; (ii) make sure the Board is open to a variety of new alternatives (i.e., if the CEO previously persuaded the Board that only one course of action is viable, the Board will point out that contradiction if the CEO later argues a contrary view); (iii) persuade the target's Board that shopping the deal to multiple bidders is both ethical and often mandated by case law; and (iv) make sure to preview what bankers propose to put in front of the Board.

Other tips to target CEOs: (i) be open to an IPO or to doing an alternative deal; and (ii) have a very sophisticated and independent Board, that is not dominated by any one individual, and that is willing to give the CEO an objective, unencumbered view, that is not tainted by self-interest or unduly focused on the short term.

If you have a strong, sophisticated Board that has realistic, risk-adjusted valuation expectations, it is fairly easy to persuade them to approve an acquisition of your company at a fair valuation. On the other hand, if your Board is not sophisticated, they will often turn down a fair deal (or refuse to waive enough of their liquidation preference to motivate the employees as required by the buyer), leaving you without strategic options going forward. So, the key job of the CEO is to select a sophisticated, flexible Board with deep experience in your space. In that regard, as a general rule, Silicon Valley VCs tend to be easier to work with than East Coast and foreign VCs, but there are exceptions. Target Boards realize that achieving the same value and liquidity via the IPO path would be very difficult, because of the time lag to get to an IPO, the risk that bankers would "go cold" on a company, the risks of being able to maintain the stock price post IPO despite variations in quarterly results, and the risk of holding the stock until the underwriter lock ups expire.

Exercise caution when a VC has an investment in both parties to a potential merger, as they may push the deal not solely due to the strategic benefits, which may be there, but also because they want to clean up and simplify their portfolio.

- **Incentivizing the R&D Team without Overpaying or Damaging Internal Morale; Retention and "Taking Care" of Your Workforce**

If you do buy a company for its technology, what is the measure of success? As John Chambers of Cisco said in a recent speech, an M&A deal is successful only if you retain the key people post deal. How do you retain the key people? Key methods are an earnout, a good job with a good title and responsibilities, fresh option grants, and so forth. The key is to fairly compensate the top performers, even if that means they make more than officers. You also have to demonstrate to the joining target employees that there is still a reason for them to come to work every day.

Employees of a start-up target, who have usually been underpaid for a long period of time, react very favorably to being paid in cash at normal buyer salaries, in addition to the upside they have in terms of liquid buyer stock. Generally the buyer's employees don't resent paying target employees on a par, or even their getting the stock upside, because they realize that the target employees took a great deal of risk, and suffered through a long period often of little or no pay, to achieve that upside, but it is worth reminding buyer employees of that, and that there is real risk in doing a start up, as many start ups fail. Certainly structuring earnouts to incentivize employees takes a lot of creativity, and the view as to the optimum earnout structure is continuously evolving. This is a very challenging issue to manage.

In general, a cash retention bonus program for [say the top 25] key target employees works well. The bonus can be payable in installments if the employees stay for specified periods, like six months and one year. This arrangement helps prevent people from leaving, but perhaps even more important, it gives the buyer the time to decide who it wants to keep, and that's critical, because it is very hard for a target CEO to figure which employees will work out once you shift from a small to a large company culture. Sometimes the small company stars just don't fit in the big companies.

Another critical point is to tolerate no resentment of differing compensation levels. The goal should be an environment based on mutual understanding and cooperation. If a CEO hears rumors, confront the disgruntled party and say, "don't blame that person for negotiating a good retention package, and it's none of your business" and that usually works well. As CEO in the combined company context, emphasize that this is now a combined team, not a pool of the conquered and the conquerors.

Another approach is to use a performance based retention bonus (which is much like an earnout). For example, you could have a retention bonus program based upon substantially exceeding the target's projected revenues. That can be a huge motivator.

In some cases, the buyer can give the target employees the ability to continue to run as an independent subsidiary in order to help incentivize retention, since the acquired engineering team can maintain its sense of identity and shared purpose. But to some extent, it is unrealistic for a target to expect continued independence, and unwise for the buyer to promise it, as it limits integration flexibility.

To avoid internal resentment and tension, it is critical to reward both internal and acquired employees who really deliver top performance on a fair basis.

A company should take care not to mislead its employees about relative compensation levels, as in that case when all the key employees' relative ownership is disclosed in connection with the disclosure documents for the deal in which the company is acquired by a public company, bitter resentment and attrition will result.

- **Valuation Tactics**

It is very difficult to persuade some targets that their valuation expectations are unrealistic, which they often are. The key is to agree on each party's synergistic contributions, and the size of the overall upside if the deal succeeds, then argue valuation from that shared understanding.

The best way to optimize value for the target is to persuade the buyer as to the target's revenue potential, as buyers generally buy seeking revenue growth. While bankers seek to persuade on this point using metrics, the real persuading is done on a CEO to CEO basis, and it requires a leap of faith. The best way for the target CEO to persuade the buyer as to valuation is to have quality customers (logos) (preferably demanding U.S. customers not smaller less well known foreign customers) and quality revenues (e.g., renewable subscription deals). Conversely, if you have less sophisticated customers and repeatability is in doubt, you will not get a great exit value.

It is very difficult for a target to understand its total potential upside, and thus to determine what valuation makes sense. It is a mistake to view a merger as an endpoint, rather than merely as a midpoint in the life of the company. If the deal is viewed as a midpoint, it becomes more clear that future revenues are hard to predict, and thus that earnouts are often a better way to price the deal to be fair to both parties.

Shopping the target, and especially obtaining a second bidder, will be very helpful in persuading the initial bidder to increase its per share bid price. Shopping the target is not a sign of bad faith — it is appropriate and often legally required. But be wary of shopping your bid before it is real, because if you shop and all bids evaporate, you can really damage your business and M&A prospects. As a public target, even if you shop and set one bidder against another, you have to expect to be sued for not shopping enough, as there's always room to be second guessed.

If you shop and generate multiple bids, have your banker let the other party know that there's another bidder, and that the original party needs to put in a preemptive bid to seal the deal. Bankers earn their money by positioning the second offer without annoying the first bidder, by helping the target to be realistic in its expectations, and by ensuring, by playing the role of middleman and mediator, that the two management teams still have goodwill despite intense negotiations. Understand that buyers can become emotional when the target informs they buyer that the target is shopping their bid; the target and its bankers should be tactful and diplomatic with the initial bidder, so the first bidder's enthusiasm is not so dampened that it withdraws its bid. Your banker can be most effective on the sell side if you have previously worked with the banker on multiple buy side deals.

Don't impair your negotiating leverage by signing a no shop too early, or by signing a no shop that has not been reviewed by M&A counsel. An ambiguous no shop can give the first bidder a large club to force the target into abandoning its shopping efforts or even its efforts to evaluate a second unsolicited bid. The key take away is, don't stop the negotiations too early.

Sometimes the target CEO can lose a deal by over-negotiating or by not being sensitive to the perceptions of the buyer's Board. For example, if the notion in a merger of equals is that the private target CEO will become the CEO of the combined public company, but that CEO comes across as an overly greedy, serial negotiator, who does not have the professionalism and good judgment required to run a public company in the post-SOX era, the buyer's Board is likely to pass on the deal.

- **Driving Your Team**

The key in managing your business development team is to focus them on what is important, then constantly reset their priorities as conditions change. Once you decide on a deal, it's critical to get all the players on both sides in a room and drive to a conclusion ASAP.

To set a good process on the sell side, have very frequent Board meetings.

Be sure you have good lawyers and accountants all along, and keep good records all along by having audited financials and good contract management.

Keep knowledge of a potential M&A deal tightly held, because if the target sales team hears about the deal, they will "take their eye off the ball", and that can impair revenues in last quarter before signing, and that can reduce your valuation.

As the target, don't push so hard to do the deal that you miss something, like achieving a fair valuation or exploring due diligence concerns that raise questions about the buyer's currency in a stock deal.

Sell Side

- **Why Sell Instead of Partnering or IPO?**

Two words: less stress. IPOs and managing a public company are very stressful on the CEO, particularly post-SOX and in the current litigation prone environment.

An acquisition at a fair price is often a far quicker way to liquidity and locking in stock gains than an IPO. Many public technology companies do not manage to keep their trading price above their IPO price over the long term. Thus, given stand backs and volume restrictions, founders and VCs with a substantial equity stake have trouble liquidating as fast as is desired. This problem is compounded by market volatility and the risk of a blown quarter.

In contrast, however, sometimes a company has not demonstrated its true upside potential, so a merger valuation would not be optimized, and it is better off doing an IPO, performing against plan, and driving the trading price up over time, than evaluating whether to stay independent or sell out at a premium to the trading price. An advantage of waiting to sell until after an IPO is that public acquisitions usually have no indemnity or escrow provisions, and shopping is not only expected but more clearly required, which helps drive deal valuations. Don't have a short-sighted view and compare M&A valuations to your initial projected IPO valuation, because that initial valuation is just a start and is not representative of long term value. View a potential IPO as a mid-point, not an endpoint.

- **When to Sell**

The optimum time to sell is when: (i) you have two to four quarters of sequential revenue growth, (ii) you are on the curve of a rapid take off and can demonstrate that momentum will continue, and (iii) you have a product that is ready to be pushed through a big distribution channel.

You may be forced to sell when: (i) you are on the brink of having to scale and you don't have the cash to scale (and you know that raising the cash will result in significant dilution), (ii) you are running out of sales bandwidth and infrastructure, sales channel, and QA capabilities or (iii) there is substantial industry consolidation, leaving the risk that all of the target's competitors will align with larger industry players, leaving the target as the "last party standing at the dance without a dance partner".

Keep in mind, though that the time to sell is often later than you think. The high-order bit for the selling company is determining when to sell. If you sell too soon, you not only lose a great deal of value, but you also lose the time when you are focused on your product development. If you sell too late, you may lose your market momentum due to lack of channel resources or due to external market changes that are hard for a small company to address. Selling too soon can affect the realized valuation by almost an order of magnitude.

One key question for the target board to ask is "how will this merger benefit the product's market share?" This is not an easy question to answer, of course. In this regard, the target is at a disadvantage because its principals typically have not been in that position before, while the buyer has.

It helps in valuation and timing deliberations to have great Board members, who not only have segment experience but also M&A experience, as well as good M&A counsel and bankers. Sometimes, the CEO and the Board must stifle the instinct to sell quickly, and have the patience to wait for the right offer to materialize after the target's true valuation potential becomes clear.

- **Obtaining a Fair Price, Shopping the Deal (for Good Process, to Maximize Price and to Reduce Litigation Risk)**

Public company targets are normally shopped extensively, receive several bids, and use a good banker. All that helps to increase the ultimate deal price. That process, coupled with frequent and deep-diving Board meetings, help set a record that demonstrates that the public target's board tried hard to consider all alternatives (including remaining independent) and obtain the best price reasonably available. Nevertheless, public target boards should expect to be sued shortly after announcement on the theory that the target was not shopped enough. However, if a good record of shopping and internal deliberations has been set, plaintiffs will often agree to settle these "strike suit" cases for small payments. So, assume a suit will be filed and conduct your public target's deal process accordingly.

Bankers will advise the board where the proposed deal valuation sits relative to a range of fair values for each metric (such as prior and projected revenues and EBITDA). One difficult issue is where the best price you can negotiate is at the low end of some of the fairness ranges, but within the range of the majority of the metrics. Here you have to rely on the banker's fairness opinion and the Board's best judgment as to the fairness of the deal terms, after careful review.

- **Avoiding Broken Deals, Managing Board Process**

To set a good record (and minimize litigation risk), you have to have a lot of Board meetings, and you need to take the time to dive deep and question your bankers and lawyers. This takes a lot of Board time, but it's like a supernova—it flashes bright then goes away. So set Board expectations accordingly.

Have your Board involved on buy side deals from day one. The best way to avoid a broken deal is to get the maximum lock up (via no shops, voting agreements, etc.) that is legally permissible, and then move quickly to sign the deal.

- **Maintaining Your Customer Base**

Customers know that when they buy the products of a small company, they can get better IP, but they want to know that their investment is protected. Make sure that customers understand the product transition path, and make sure that they know that you, as target CEO, are personally committed to ensuring they have a smooth transition. One effective approach is for the CEO to actually visit all key customers, to persuade them you will go above and beyond the call of duty to make sure they are taken care of by the buyer.

Even if you have to swap customers from the target's to the buyer's product, you can still retain the customers if you act in good faith and the replacement product is viewed as superior (it helps if there are no realistic competing products). Unless it is widely perceived that the acquisition was done to kill the product, there is little risk of customer attrition due solely to a change in control.

- **Lessons Learned**

The key to doing deals is to buy targets with a great, high quality team, that interacts well internally and with your team. If they are talented, they will earn the respect of your team.

Dig in on diligence even if you are the target and the buyer is public. If you take the stock of a buyer, ask the hard questions about the long term stability of the buyer's currency and business. If you accept an earnout payable in cash over time, assure yourself that the buyer will be around to pay off the earnout.

Targets should not be overly sensitive about bona fide buyers conducting diligence—buyers are deeply concerned about liability, and they will almost always conduct themselves in accordance with legal requirements (i.e., not misuse your trade secrets). However, be wary of preliminary inquiries by "prospective" business partners who really are just seeking competitive intelligence.

Keep in mind that mergers are hard and many don't work.

Work to manage your Board and your founders.

It is critical to have the sophistication to manage your lawyers, as the lawyers on both sides will tend to be aggressive with each other, and you don't want them blowing the deal up over trivial legal technicalities. Learn to hear what the risks are, and make clear to counsel that you understand that risk, and want to move forward anyway. Never be frozen by legal risks.
