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Mergers and Acquisitions Basics

The Key Steps of Acquisitions, Divestitures, and Investments

Second Edition

MICHAEL E. S. FRANKEL
LARRY H. FORMAN

WILEY

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Preface

The nature of business is a moving target. The way markets and businesses operate is constantly evolving, changing, and developing. For those who study business, this is a source of new data, and for those who conduct business, it is a source of a constant stream of new challenges and opportunities. Transactions, deals, agreements, or contracts are as old as commerce itself. However, in recent decades, transactions involving control of business entities themselves have become far more common.

Mergers, acquisitions, divestitures, equity, and venture investments are all forms of what we refer to in this book as *Strategic Transactions*. Strategic Transactions are unique in several respects. Unlike other commercial contracts and agreements, Strategic Transactions are dramatic events for companies and often represent either the end to a company as an independent business or a dramatic change in its management, ownership, or fate.

Since the 1970s, Strategic Transactions have evolved from rare events to a common business practice. Today, most large companies have an active, ongoing acquisition effort, and most small and private companies consider being acquired a possible and sometimes likely end game. Strategic Transactions, in the form of private equity and venture capital investments, also represent a large and increasing source of capital for new and growing businesses.

As Strategic Transactions have become a common and popular business tool, a new class of business professionals has emerged to manage and execute these deals. While professional advisors such as investment bankers, lawyers, and consultants have long been expert at structuring and executing Strategic Transactions, today this segment of the advisor community is larger than ever.

More important, a class of business professionals who are experts in doing Strategic Transactions has emerged within companies: the corporate development professional. Some of these corporate development professionals learn their craft as bankers or lawyers while others are developed within a company. Business schools now devote coursework to the art and science of deal making as a specialty. Many companies now have chief corporate development officers. Doing deals has become a defined and recognized business specialty like marketing, finance, and operations. We may even suppose that this is a virtuous cycle where the increasing population of deal experts will lead to an increasing use of Strategic Transactions as a business tool and source of inorganic corporate growth, in turn leading to the development of more deal experts.

In addition to the growing population of professionals both inside and outside of companies who make a career of deals, there is a growing legion of business executives who are involved in Strategic Transactions. It is rare to find a manager or executive who has not found herself involved at least tangentially in an acquisition, divestiture, or other Strategic Transaction.

The goal of this book is not to provide an all-encompassing and definitive treatise on Strategic Transactions. Many books have been written by legal, finance, and accounting experts delving into tremendous detail on the mechanics and features of Strategic Transactions. The goal of this book is to provide the reader with a primer and overview of the key steps and features of most deals.

We hope that this book will be read by both young professionals starting to develop an expertise in Strategic Transactions and also by a wider range of business executives who find themselves involved in deals. For the young corporate development executive, investment banker, lawyer, or consultant, this book can provide a foundation for understanding deals, on which they can build a deep expertise and specialty. For business executives and managers, the book can hopefully provide a complete and easy-to-read overview to help them navigate a deal and their role in it.

We have sought to balance the need for detail with ease of understanding, and to add a measure of fun and humor to a serious and complex topic. As the reader navigates this book, and then a career with some or perhaps many deals, we hope she will not only learn vital lessons to ensure her success but also share some of the huge enjoyment we have found in the infinite challenge and complexity of doing deals and building businesses.

Acknowledgments

This book is the result of months of writing, but also of years of work and dozens of deals. The knowledge we try to share comes from more than five decades of work with a myriad of smart, accomplished, talented, and kind professionals. We owe a debt of gratitude to our colleagues, clients, and friends from GE, VeriSign, Merrill Lynch, Skadden, Arps, LexisNexis, Dinsmore & Shohl, Deloitte, and the Chicago Mercantile Exchange for their guidance, wisdom, and mentoring.

We could not have written this book without the help and wisdom of Shayna Klopott and the invaluable assistance of Gail Nurnberger. We also need to thank our families and friends, including Ernst, Tamar, Ray, Inna, John, Betsy, Patty, Joan, Pauline, Celeste, Jackie, Anat, and, in the case of Michael, his daughter Sophie, who is the inspiration for everything he does. Their kindness and intelligence also run through this book, as with every part of our lives.

Of course, while any wisdom or insight can be attributed to our time with these people, any errors or mistakes are entirely our own.

Mergers and Acquisitions Basics

CHAPTER 1

Introduction

M&A, deals, buyouts, LBOs, MBOs, private equity, venture capital, corporate development, and a myriad of other terms are used to describe large transactions that fundamentally change the nature or course, and control, of a company. Although there are many differences among these different types of deals, a common thread runs through all of them. They are all *Strategic Transactions* that involve a change or shift in control of a company and usually a corresponding shift in strategic direction.

There are many different types of transactions done by a company during its life cycle. Companies execute agreements with suppliers, customers, partners, regulators, and financiers almost constantly. A lawyer would argue that running a business is really a long series of contractual obligations, entered into, complied with, and terminated. At any given time, most companies are entering into new agreements and consummating new transactions on a daily, even hourly, basis.

Strategic Transactions are different. They are the seismic, life-changing events that fundamentally alter a company. They usually change not only who controls the company but also the strategic direction the business will take. They sometimes take a public company private or make an independent company into a small subsidiary. While full acquisitions are the most commonly known Strategic Transactions, there are many variations on the theme. However, all Strategic Transactions have a lot in common. They all involve a substantial or total change in control and a large amount of money (or other form of payment) changing hands. They all involve a *Buyer,* who will want to learn a tremendous amount about the business and understand it deeply. They also all involve a *Seller,* who is trying to maximize the value of its business but also often has other interests, including the long-term partnership it may be entering into with the Buyer and the fate not only of its business but also of its employees.

Over the past few decades, Strategic Transactions have played an increasingly important role in business. Companies turn to Strategic Transactions as an alternative to investment in their organic growth or when obtaining capability via strategic alliances does not provide the necessary control and/or economic value. From the growth of private equity investments in a variety of forms to the increasing use of acquisitions as a growth tool by large, and even midsized, companies, Strategic Transactions have become a standard and common part of the business landscape, fueling the growth of large and small companies. There is a long-term upward trend in both the volume and average deal size of acquisitions in the United States. Exhibit 1.1 shows that US M&A (measured in terms of dollars) remained on a substantial upward trend over the past two decades despite the downturn during the collapse of the tech bubble in 2001 and 2002, and the 2007–2009 financial crisis (aka the Great Recession). More recently, even though deal volume in 2015 was about the same as deal volume in 2005, during this 10-year time period the total dollars spent on US M&A activity grew at a compounded annual growth rate (CAGR) of 5.9 percent.

While the increased dollar spend, and hence average deal size, are partly explained by inflation, the increase in dollar volume is a clear indication that Strategic Transactions continue to be a core tool of growth for US companies. The recent trend is even stronger. Looking at the period coming out of the Great Recession, 2009–2015, both deal volume and total dollars spent on transactions increased, 3.6 percent CAGR and 18.1 percent CAGR, respectively, as the economy recovered.

Many of the largest US technology companies today received their early funding from venture capital and private equity investments, and many of the largest and most established names in business, including IBM, General Electric, and Pepsi, as well as newer stars, such as Oracle, Google, and Cisco, drove a significant part of their growth through acquisitions. (*Note:* More on corporate M&A will be discussed in Chapter 2.) For the 11-year period of 2006–2016, US venture capital raised increased from $36.4 billion (2006) to $41.6 billion (2016)—see Exhibit 1.2. However, during this period, venture capital raised declined dramatically in 2009 as a result of the impact of the Great Recession and did not again reach even 2007's level of ~$35 billion until 2014. Most recently, US venture funds secured $41.6 billion in 2016, an 18.2 percent increase over 2015's $35.2 billion. This new capital will likely be put to use over the next five years.[1]

Private equity (PE) firm investment is one form of M&A activity in that PE firms are generally buying *companies* for their own investment portfolio. In the last decade (2006–2015), despite the Great Recession of

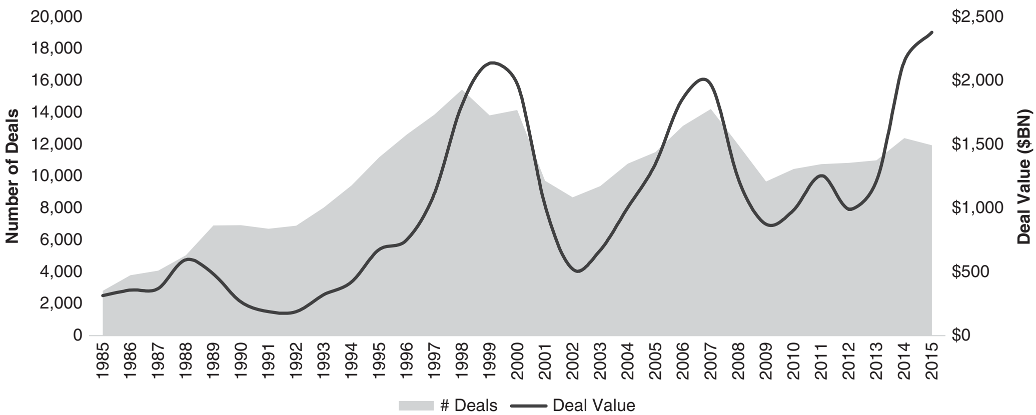

EXHIBIT 1.1 Historical US M&A Activity
Source: https://imaa-institute.org/statistics-mergers-acquisitions/#Mergers-Acquisitions-United-States-of-America.

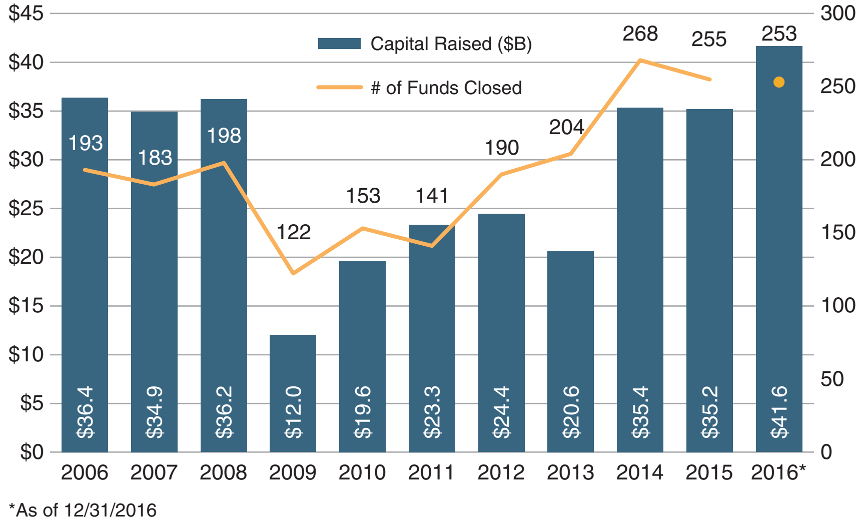

EXHIBIT 1.2 US Venture Capital Commitments
Source: NVCA 4Q 2016 US Venture Monitor, page 17, National Venture Capital Association.

2007 to 2009, US private equity firms increased their *investment*—that is, their M&A activity—from $487 billion in 2006 to $632 billion in 2015 (see Exhibit 1.3). When you look at the money available for M&A activity globally (so-called *dry powder*), the same pattern emerges. A near record $1,307 billion was available at the end of 2015, up from $800 billion at the end of 2006 (see Exhibit 1.4). The signs are clear that M&A activity will increase as these funds are eventually put to use across all sectors of the global economy.

However, Strategic Transactions are not a riskless exercise; far from it. Although they can be a source of dramatic and quick growth when they are successful, they can be a huge drain on a business when they fail to deliver. In what is often known as the *winner's curse,* many studies find that most of the value derived from many deals ends up in the hands of the Seller rather than the Buyer.[2] Often, this failure is the result of a gap between the cost and revenue synergies expected and actually realized. In some cases, this is the result of optimistic expectations, and in others, of a failure to execute effectively on integration plans.[3] One study found 64 percent of the deals studied destroyed value for the Buyers' shareholders.[4]

This book will provide an overview of all the key steps in a Strategic Transaction and try to provide the reader with not only an overview of how

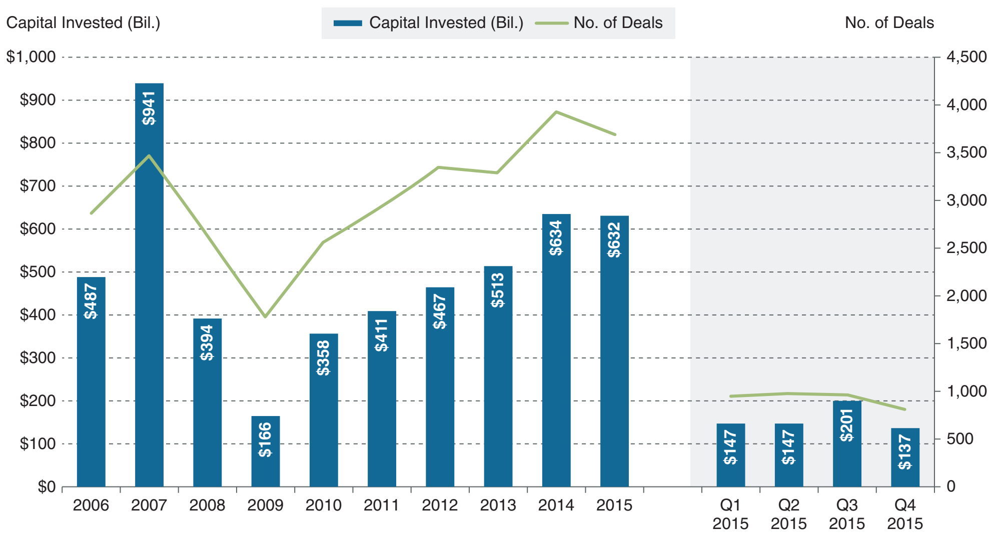

EXHIBIT 1.3 US Private Equity Investment
Source: Private Equity Growth Capital Council website (now the American Investment Council).

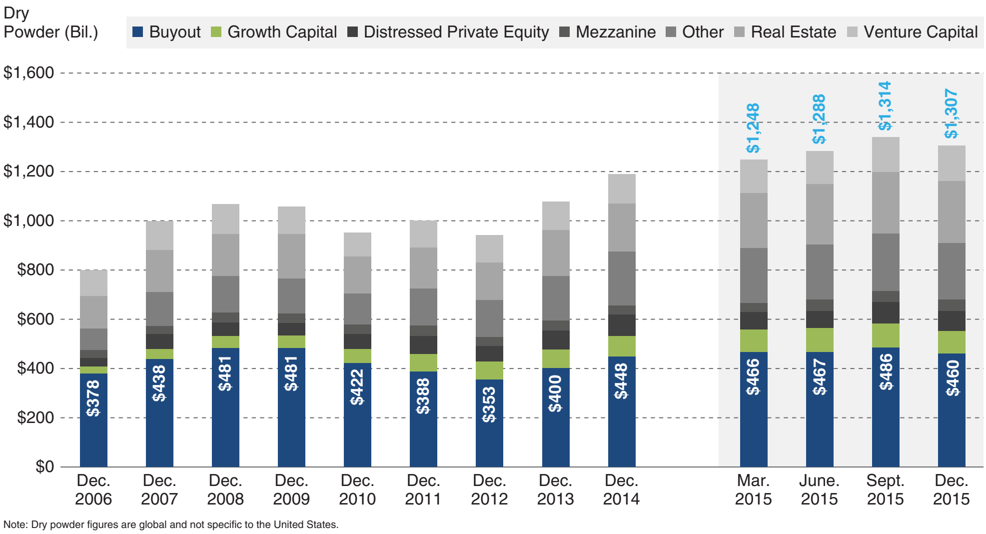

EXHIBIT 1.4 Global Private Equity Dry Powder
Source: Private Equity Growth Council website.

the process works but also key lessons for how to approach and execute a deal effectively and efficiently. Many sections will discuss each side—Buyer and Seller—individually; however, it is important for any participant in a Strategic Transaction to understand both sides. Too often, a Strategic Transaction falters, or the parties do not reach the optimal terms, because one side fails to understand the other. Buyers need to understand the needs of a Seller and try to reflect them in their bid. Sellers need to understand the goals of a Buyer and manage their business to meet those goals. This can not only help to get a deal done but also, in many cases, result in a deal that is better for both sides.

One of the interesting things about a Strategic Transaction is the potential for synergy, where one plus one equals three. The combination of Buyer and Seller can create additional value to be shared. For example, a company that is undercapitalized can actually return dramatically better results once it is owned by a larger parent with more access to capital. Similarly, a small technology company with an innovative product might be worth much more when combined with the marketing power of a large, branded electronics manufacturer. In each case, the Strategic Transaction itself unlocks additional value that neither side could access individually. One of the keys to unlocking this value is a clear understanding of the other party's goals, challenges, and processes. Understanding the Buyer will make you a more effective and successful Seller, and vice versa.[5]

Chapter 2 reviews all of the key players in a Strategic Transaction. The goal here will be to discuss not only the role of these players but also their motivations and goals. This chapter will also differentiate between the goals of organizations and the individuals who run and represent them. Chapter 3 discusses the decision to buy or sell. Many of the terms, as well as the nature of the process of a transaction, will be driven by the underlying decision made by Buyer and Seller to do a deal. Chapters 4 and 5 discuss first the Buyer's preparation and then the Seller's preparation for a deal. Investing time and resources in preparing for a Strategic Transaction can yield dramatic returns. Given the large dollar amounts at stake, proper preparation is always a worthwhile investment.

Chapter 6 discusses the deal process. Given the complexity of a Strategic Transaction, how the process is crafted can actually contribute to the success of the deal. Chapter 7 will focus on the core of a Strategic Transaction—due diligence. This is the period during which the Buyer tries, in a relatively short period of time, to get a sufficiently detailed understanding of the business for sale to have comfort that its price is reasonable and its plans for growing, expanding, or otherwise improving the business are feasible. This is also an opportunity for the Seller to further pitch the value of the asset and to try to allay any concerns that the Buyer may have. Effective due diligence is the key to avoiding nasty surprises after a deal is done, and failure to do proper due diligence can leave a Buyer owning a business much less attractive, less profitable, or simply much different from what the Buyer thought it was buying.

Chapter 8 will discuss valuation, arguably the core of a Strategic Transaction. The fact that a valuation is expressed in terms of a single or small range of numbers belies the fact that the process, part art and part science, of reaching this number is often complex and unclear. Chapter 9 will review the often ignored issue of integration planning. For most Buyers, effective integration planning can be the difference between success and failure in a Strategic Transaction. While actual integration takes place after a deal is done, integration planning is an essential part of the transaction itself, since it both informs the other parts just mentioned (valuation, due diligence, and even the decision to buy) and helps to ensure that the actual integration can occur quickly and efficiently after the deal is closed. Chapter 8 also touches on financing issues that the Buyer may face. While some Buyers have sufficient capital on hand to do a Strategic Transaction, some large and relatively rare deals often require outside financing, and this has an impact on both the Buyer and the Seller. Chapter 10 will also discuss such financing issues.

Finally, Chapter 11 will discuss some of the mechanics of actually closing a deal and some of the "tail" issues that remain after a deal is closed. Every deal is unique and, by definition, requires a tailored set of documents. That said, some standards, forms, and checklists can be a valuable starting point. In the appendices are examples of reports, checklists, process maps, and term sheets that can help the reader flesh out the deal process.

The key steps, challenges, and processes in all Strategic Transactions are very similar. While this book will focus on the most common, the acquisition of an entire company, most of the lessons are equally applicable to transactions involving the acquisition of a strategic stake in a company as well.

NOTES

1. NVCA 4Q 2016 US Venture Monitor, page 17, National Venture Capital Association.
2. Scott Christofferson, Robert McNish, and Diane Sias, "Where Mergers Go Wrong," *McKinsey Quarterly* 2 (May 2004), p. 2.
3. Ibid. The authors found that in 70 percent of the deals studied, the Buyer failed to achieve the expected levels of revenue synergies, and in 25 percent of the deals the Buyer substantially overestimated cost synergies.

4. "Of 277 big M&A deals in America between 1985 and 2000, 64% destroyed value for the acquirers' shareholders. Interestingly, mergers in recessions or periods of low growth from 1985–2000 did better than mergers consummated in good times." In "The Return of the Deal," *The Economist* 368, issue 8332 (July 10, 2003), p. 57.
5. For a much more detailed discussion of this topic, see Michael E. S. Frankel, *Deal Teams: The Roles and Motivations of Management Team Members, Investment Bankers, Venture Capitalists and Lawyers in Negotiations, Mergers, Acquisitions and Equity Investments* (Boston: Aspatore, 2004).

CHAPTER 2

The Players

You cannot understand a Strategic Transaction without understanding the players involved, their roles, their motivations, and the way transactions are managed. Beyond the Buyer and the Seller, there are many entities that participate in a Strategic Transaction. Beyond the entities, it is as important, if not more important, to consider the individuals. In many cases, individuals within an entity and the motivations that drive them can have a substantial impact on a deal. This chapter will review the major players in a Strategic Transaction. It will discuss what role they play, how they are motivated, and how they are managed.[1]

THE BUYER

In this book, the *Buyer* is the entity rather than the individuals who may represent it. Subsequent sections will briefly talk about the individuals who may be sitting across the table from you in a negotiation. In theory, people who work for an entity should exactly represent its best interests, but in practice this is not always the case. In this section, think of the Buyer as a corporate entity maximizing its and its shareholders' best interests.

Buyers come in many forms with different goals and motivations. When negotiating with a Buyer, it is essential to understand the Buyer's business model and priorities. Similarly, as a Buyer, it is important to first establish what your priorities are to ensure that a Strategic Transaction meets your company's specific goals.

Strategic Buyers

When people refer to strategic Buyers, they are usually referring to corporations that are making an acquisition to bolster their existing business. A better and broader definition might be that a strategic Buyer is an entity making a purchase that it intends to somehow consolidate, link, or integrate with other operations that it owns. Strategic Buyers will be differentiated from financial Buyers shortly. Strategic Buyers generally view an acquisition in terms of the impact that it will have on the Buyer's existing business and the impact that the Buyer's existing business can have on the acquired business. These can be defined broadly as *synergies*. Chapter 8 will discuss synergies in detail, but for the moment suffice it to say that synergies are the exercise of making 1 + 1 = 3. To the extent that a strategic Buyer can recognize synergies through an acquisition, it has an inherent advantage. In effect, it can buy something for $10, but by virtue of buying it and integrating it effectively, can make it worth $11 or more. However, as will be discussed in this chapter, synergies presume an effective and efficient integration. This is a far, far more daunting task than most acquirers expect.

Strategic acquirers have an additional advantage. Unless they are looking to acquire a business in a wholly new area, a strategic acquirer will have a fairly deep understanding and knowledge of the business, markets, operations, and customers of an acquisition Target. A strategic acquirer will also be able to call on its own staff to provide detailed expertise when reviewing an acquisition and considering the challenges of integration.

Repeat Players For many companies, acquisition has become a standard business tool. Companies like Cisco, Google, HP, and Oracle drove growth through acquisition and effective integration. In fact, of the top 10 largest tech acquisitions to date, Oracle bought PeopleSoft ($10.3 billion) and Sun Microsystems ($7.4 billion), HP bought Compaq ($18.6 billion), EDS ($13.9 billion) and Autonomy ($10.2 billion), and Google purchased Motorola Mobility ($12.5 billion).[2] Google, a serial acquirer, has bought more than 180 companies since its first acquisition in 2001.[3] But tech isn't the only active sector for M&A. During the period from 2010 to 2013, some of the largest companies in the healthcare market did multiple deals, with GE completing 10 acquisitions, Pfizer completing 7, and Medtronic 6.[4] Exhibit 2.1 lists the most active healthcare acquisitions.

The tech sector has been acquiring many private companies. The "top tech acquirers of 2009 made 55 disclosed private company acquisitions compared to the 200+ that have taken place" through September, 2014[5] (see Exhibit 2.2). "Five companies consistently rank in the top tech acquirers by year: Google, Facebook, IBM, Cisco, and 3D Systems."[6] Exhibit 2.3 contains a list of the largest deals *announced* in 2013 to 2015, deals ranging from $10 billion to $191 billion, representing a variety of industries as well. What's interesting to note is that not all of these deals were completed due to regulatory or other issues. For example, Time Warner Cable did not get acquired by Comcast in 2014 as announced, but in 2015, Charter

Company	Ticker	Investments	Acquisitions	Total
Novo Group	NYSE: NVO	51	1	52
Johnson & Johnson	NYSE: JNJ	41	3	44
Novartis	NYSE: NVS	39	1	40
GlaxoSmithKline	NYSE: GSK	34	4	38
Pfizer	NYSE: PFE	23	7	30
General Electric	NYSE: GE	18	10	28
Roche Holding	Six Swiss EX: ROG	16	4	19
Medtronic	NYSE: MDT	14	6	20
Eli Lilly & Co.	NYSE: LLY	16	3	19
Kaiser Permanente	N/A	19	0	19

EXHIBIT 2.1 The Most Active Healthcare Corporate Acquirer-Investors, 2010–2013
Source: cbinsights.com.

announced the acquisition of Time Warner Cable, which closed in 2016. The Williams–Energy Transfer Equity deal, was announced in 2015, but collapsed in 2016. And the Anthem–Cigna deal announced in 2015 has been blocked by the Justice Department on anti-trust concerns. As of September 2016, it was still in limbo. Despite the challenges associated with such large acquisitions, the activity continues with new announcements almost daily.

Repeat players have several distinct advantages even over other strategic Buyers. The most obvious and powerful is that they have learned through experience and through trial and error. Repeat players have honed their ability to evaluate, negotiate, close, and integrate Strategic Transactions. They have learned what they do well and what they do not do well. In terms of governance, repeat players have learned how to quickly and efficiently navigate their own internal approval processes for Strategic Transactions, which inevitably attracts senior management's attention and scrutiny. Part of this is that the senior management and boards of repeat players have gotten more comfortable with the inherent risk and volatility of Strategic Transactions. Repeat players have also developed dedicated expertise in their staff to do these deals. Repeat players usually have dedicated deal teams and standardized procedures, documents, and models. More broadly, repeat players usually develop a general understanding among their broader management and employee base of the role and purpose of strategic acquisitions. This makes both drawing resources to do a deal and the process of integrating a deal less traumatic for the organization and its employees.

EXHIBIT 2.2 The Top Tech Acquirers, 2009–2014
Source: https://www.cbinsights.com/blog/tech-acquirers-private-companies/.

Newbies and One-Timers Like anything else in life, there is always a first time for doing deals. For some companies, a first Strategic Transaction is the first step in becoming a repeat Buyer—a serial acquirer. For other companies a Strategic Transaction may be an aberration or a one-time event, which is unlikely to be repeated. There is also the third category—occasional Buyers. While occasional Buyers are not as unsophisticated or unprepared as first-time Buyers, they do not have the same infrastructure, experience, and capabilities that a repeat Buyer has.

For first-time Buyers, a Strategic Transaction is far more frightening and far more risky than for a repeat Buyer. For them, it is not only far more expensive in terms of dollars spent, but also, more importantly, in terms of resources that must be devoted and the distraction to senior management

Largest M&A deals in 2015

Rank	Companies	Industry	Price ($ Billions)
10	Ebay and Paypal	Internet	47
9	Anthem and Cigna	Healthcare	48
8	Heinz and Kraft Foods	Food Processing	55
7	Energy Transfer Equity and Williams	Energy	56
6	Dell and EMC	Technology	66
5	Dow Chemical and DuPont	Chemicals	68
4	Charter and Time Warner Cable	Telecommunications	78
3	Shell and BG Group	Energy	81
2	Anheuser-Busch InBev and SABMiller	Beverage	120
1	Pfizer and Allergan	Pharmaceuticals	191

Largest M&A deals in 2014

Rank	Companies	Industry	Price ($ Billions)
10	Novartis AG & GlaxoSmithKline	Pharmaceuticals	20
9	Facebook and WhatsApp	Internet	22
8	Actavis and Forest Laboratories	Pharmaceuticals	25
7	Reynolds American, Inc. and Lorillard Inc.	Tobacco	27
6	Halliburton Company and Baker Hughes Incorporated	Oil Services	35
5	Medtronic and Covidien	Healthcare	43
4	Actavis and Allergan	Pharmaceuticals	66
3	AT&T and DirecTV	Telecommunications	67
2	Comcast and Time Warner Cable	Telecommunications	70
1	Kinder Morgan Inc. and El Paso Pipeline	Energy	76

EXHIBIT 2.3 The Largest M&A Deals Announced in 2013–2015
Sources: CNBC.com and Investorplace.com.