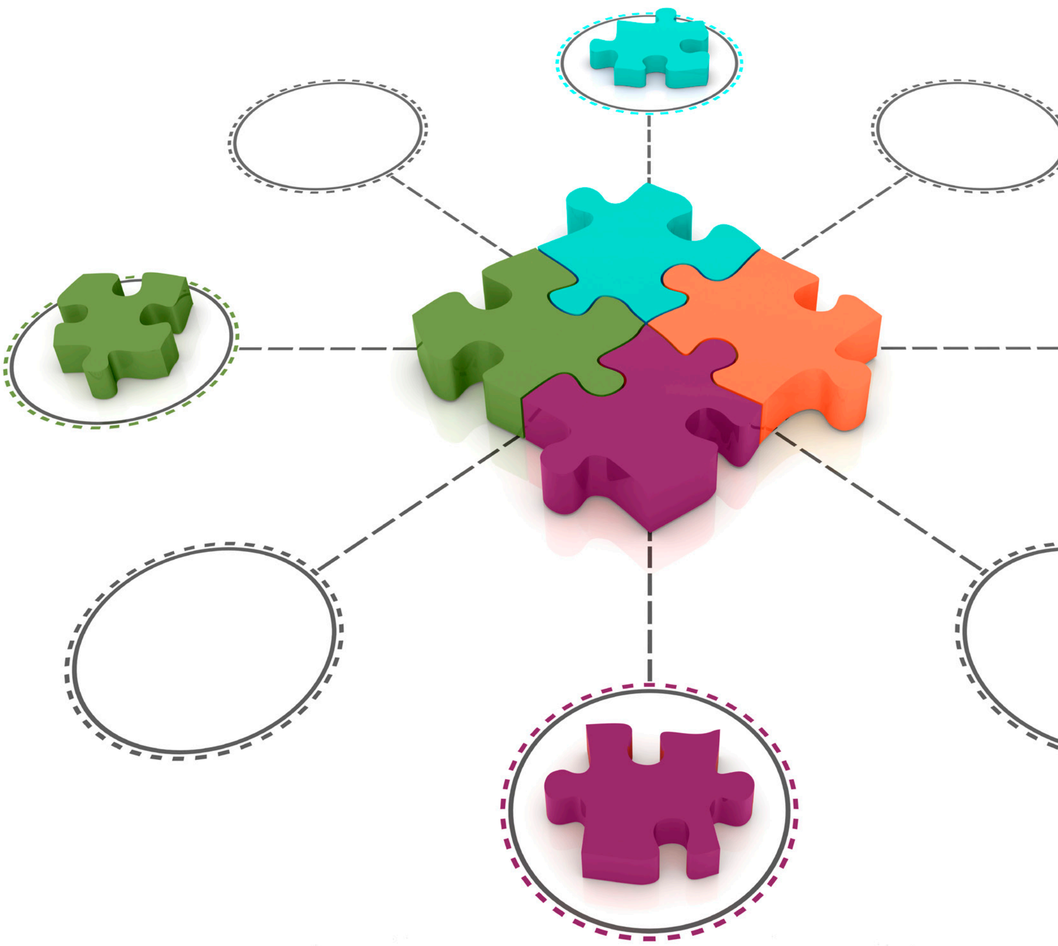
SQUIRE SANDERS

MANAGING M&A PROCESS TO CREATE VALUE

WHAT EVERY CEO SHOULD KNOW



INTRODUCTION

Growth is hard to come by. In many sectors, customers are deferring buying decisions, and new revenues are elusive. With uncertainty as to when things might improve, CEOs are turning to mergers and acquisitions in pursuit of growth. And, with the domestic market stalled, companies are increasingly looking to foreign and emerging markets for their acquisition targets.

In an environment where even a temporary earnings hiccup will be punished by the public markets or undermine private investor confidence, getting it right when doing an acquisition is essential. Enhanced regulatory scrutiny and the willingness of regulators to hold acquirors responsible for the sins of acquired companies combine to further heighten the stakes for a CEO seeking to assure that an acquisition will create rather than destroy value.

A CEO betting that a significant acquisition (or a series of smaller acquisitions) will jump-start growth must be aware of the importance of a sound M&A process. While a good process cannot guaranty success, a poor process can virtually assure failure.

Research indicates that there is a strong correlation between the company's M&A competency and the results achieved through its acquisitions. The more often a company is involved in the M&A process and the larger its transactions, the greater its need for a well-designed methodology and a high-functioning and dedicated team to manage risks and increase consistency. By contrast, those who only occasionally participate in the acquisitions arena will tend to treat a transaction as an individual project to be managed with "one-off" approaches and a temporary project team assembled for the specific purchase.

Thus, individual companies will vary their practices depending upon circumstances, but there are some general rules that can enhance the likelihood that a deal will positively impact the company's future.

Successful acquirors are more effective at using their business units and support staff in the due diligence process.

Design The Process; Don't Just Let It Happen

Veteran M&A warriors understand the importance of designing the acquisition process with the particular target, transaction, and desired result in mind. Timing considerations can be paramount, and the ability to move quickly is often crucial. By the same token, sufficient time must be provided in ordered to allow for an adequate pre-purchase investigation.

When designing the investigation, some consideration should be given to the following:

- **Who Should Be Involved?** Some companies chose to involve only a small core team of M&A professionals in their acquisition activity. In other instances, involving line managers and support functions who will be responsible for the operations and integration of the target business can be helpful and appropriate. The right answer for the particular deal is important. The company may not have the right (or sufficient) internal resources, particularly if it is an infrequent acquiror. It is important not to strain the company's existing operations by diverting already-busy managers. Augmenting the team with a financial advisor and legal counsel familiar with the issues presented in the M&A process may help to shore up the team and complete the transaction in a timely manner. Research suggests that successful M&A teams generally devote more and more specialized resources to their transactions than do average performances.

- **What Will Be The Focus Of The Acquisition Investigation?** The nature of the acquisition investigation will be governed by deal-specific factors including the key strategic or other drivers for the transaction, unique risks in the industry, target-related risks, regulatory issues, tax concerns, countries of operation, employee issues and the like. The scope of the investigation should be well thought out, and should be reflected in any due diligence document requests and reports.

- Involving The Business Units. Successful acquirors are more effective at using their business units and support staff in the due diligence process. This allows for greater insight from those who are on the front lines of the business and helps to secure early "buy in" from these managers. In companies with decentralized operations, a distinction is generally drawn between the role of the central M&A support team and the decentralized business managers who will drive the analysis and terms of the transaction, as well as the operation of the business following closing. When a company has established such a "core competency" for executing M&A transactions within the headquarter operations of the company, that core team will generally control the process, while the business managers and operators will often control the decision making that leads to the consummation of the transaction.

- **Include Those Who Will Ultimately "Own" The Success Of The Deal.** In larger enterprises with decentralized operations, the acquired business will not be operated directly by the CEO, but by another business leader. Including that business leader and his or her team in the acquisition process will be crucial to achieving accountability and a smooth integration. Whoever "owns" the success of the acquisition following closing, should have a strong voice in controlling the decision making during the acquisition process.

- **How Will The Deal Team Report In?** As various participants in the due diligence process complete their review, thought should be given to how this information will be assembled and shared within the M&A team. Some companies choose to have the information funneled into a single small group who digests all of it. In other circumstances, companies believe there is value in having the information shared more broadly within the deal team so that patterns may emerge. Sloppiness in one area may simply be indicative of a weak department. Sloppiness in multiple areas may indicate a deeper problem. When information is shared more broadly, transaction participants may realize that factors that they initially shoved aside as insignificant were, in fact, important

- **Develop Written Work Plans.** A written work plan, including a timetable and responsibility checklist, is crucial to driving the process. Assigning specific tasks to internal or external resources and having everyone know who is doing what and when is as important in an M&A transaction as in any other group project. Use of computerized scheduling resources and intranet and work share programs can aid in this task.

- **Don't Forget IT.** Information technology and enterprise systems within the target are a crucial issue in an acquisition of any size. If the target's systems are not up to par, or cannot readily be integrated with those of the acquiror, delays in financial reporting can result and costs to bring the systems to par can be surprisingly high. In addition, while systems improvement is in process, managers will not have the information needed to successfully integrate the target

  An IT integration plan will be crucial. If the combined technical resources of the acquiror and target are not sufficient to implement the integration, thought must be given to utilizing outside resources. Costs should be factored into valuation models and financial forecasts. For public companies with reporting obligations and potential exposure under federal securities laws for lapses in internal controls, this can have serious legal implications.

What Is The Negotiation Strategy?

Entire books can (and have been) written on negotiation strategy. The right strategy will depend upon the nature of the transaction and the character of the target. If the target has initiated the process as a limited or full auction, the buyer will generally not have as much control unless and until it obtains rights to conduct exclusive negotiations for a defined time period (often 30-90 days). In other situations, the buyer can exert more control over the shape of the negotiation process, including whether and when offers will be exchanged, which issues will be negotiated first, who will be involved in the negotiations and the like. It may be appropriate to establish separate negotiating teams to deal with individual issues, while in other cases, having all issues negotiated by the same team can be helpful in setting up "tradeoffs" that may help bring the deal to a more prompt conclusion. The CEO should be involved in shaping and overseeing the strategy and should be aware of each major "move" in the negotiations. Often, the CEO's participation in a final session to reach agreement on open issues can be a very effective tactic, particularly if the CEO has remained "behind the scenes" throughout much of the process.

Focus On The Target's Culture, Not Simply Its Past Results

Perhaps the single most important thing that a CEO does in his or her organization is to create and manage the culture. When a business is being acquired, its culture may (or may not be) a good match with that of the acquiror's. Unless the cultures mesh (or can be made to mesh quickly following the acquisition), friction is likely to result, and the hoped-for results from the transaction may be more difficult to obtain.

Employees who are accustomed to doing things one way can quickly grow to resent significant changes in their daily routine. If the target's culture is more free-flowing, while the acquiror's culture is more structured and "top-down," frustration is predictable. Conversely, if the target's employees are accustomed to having their every move directed from above, and then find themselves in a culture where employees are expected to be self-directed, wandering can result. Thoughtful planning about culture gaps and differing management styles is crucial.

Buying a dysfunctional or dishonest culture is the hidden risk in any acquisition. Integrity is paramount and indications that it is lacking in the target is usually a danger signal that the transaction does not make sense.

What Can The Target Do That We Cannot Do?

Some acquisitions are motivated solely by a desire to increase the size or scope of the resulting enterprise, while in other cases, synergies in the form of cost reductions are the motivating factors. More often, however, acquirors seek out a target that brings some additional value to the table in the form of intellectual property, strong management, specific customer or supplier relationships, complimentary products or other strategic advantages.

Generally speaking, the business contacted by the target should align with and advance the strategy of the acquiror. In a very real sense, acquisitions are "make versus buy" decisions in which the acquiror elects to purchase a particular capability rather than develop it organically. It is generally accepted that the costs of an acquisition exceeds that which it would take to grow the same assets organically; however, the acquisition allows progress more quickly. Where speed is not crucial, however, companies may wish to rethink whether an acquisition versus internal development of the capability makes sense.

It is important that the CEO adequately and clearly communicate to the deal team the drivers for the particular acquisition. Armed with this information, the deal team can perform its due diligence and negotiation functions more effectively and with greater focus. Knowing what you are trying to achieve and what you are trying to protect and capture is crucial.

What Can The Target Do That We Cannot Do? – Part II

Closely tied to the issue of culture is the manner in which the target conducts its business. The target may have compensation practices (particularly in the way it awards its sales performers) that are inconsistent with the acquiror's practices. Thought must be given to assess whether it will be possible (and necessary) to maintain those differences following the closing, or whether the target's pay practices must be modified, risking departure of key players.

The target's arrangements with its customers must also be examined. Are the target's warranties, return policies, or other dealings with its customers inconsistent with the way in which the acquiror deals with those issues? Once again, an assessment must be made as to whether those differences can or should be maintained and the impact of changes should be reflected in financial plans and models.

The way in which the target secures its business is also an area of increasing concern, particularly in emerging or foreign markets, or in cases where the target does business with domestic or foreign governments. If the target uses intermediaries or gatekeepers or pays incentives or facilitation fees that the acquiror cannot lawfully continue following the transaction, the anticipated loss of business should be quantified and modeled as best as possible. If the target is succeeding by doing things that the acquiror cannot do, the question must be asked: "Will the business succeed when we own it?"

Pick And Choose To Build The Best Team

Companies that undertake an acquisition will often have an opportunity to inject new talent into their organization. Those companies who pursue multiple acquisitions over time can utilize their acquisitions to repeatedly upgrade their talent pool. Similar to adopting "best practices" acquirors should repeatedly select the best people from each organization to drive the combined enterprise following closing.

Choose The Right Structure To Manage Risks

The CEO and his internal and external legal team should confer about the best acquisition structure to manage risk, while still accomplishing the business goals for the transaction. The purchase of assets and the assumption of identified liabilities (versus the purchase of the target's stock) will typically produce a more controlled risk profile. However, the acquisition of assets is not always possible due to tax concerns as well as the inability to convey key contract rights, licenses, or permits. Understanding the options and balancing the risks and rewards associated with various structures will fundamentally be the decision of the CEO, as the company's "Chief Risk Officer."

Risks can further be managed and mitigated through the well-structured use of representations, warranties and indemnification, and through the use of either purchase price holdbacks or escrow funds. In certain transactions, such as the acquisition of a public company, indemnification arrangements cannot be secured. In the absence of such arrangements, where the buyer essentially is proceeding on an "as is and where is" basis, the importance of due diligence and thoughtful investigation is heightened. Many experienced acquirors work hard to at least maintain their ability to sue a seller for misrepresentation or fraud, even where broader contractual indemnification rights are not obtained. Finally, care must be taken to understand, and preserve (or enhance) the target's general business insurance.

Understanding the way in which business is done in the target's sphere of operations is crucial.

Cross-Border Deals Are Different

Entering a new market through acquisition can jump start the financial growth of a company. On the other hand, acquiring a business in one or more countries where the acquiror has never previously operated is replete with challenges, particularly where the acquiror's organization has no experience with foreign operations. Augmenting internal resources with country-specific experts can mitigate the risks associated with the acquisition, but caution is still the watch word.

Understanding the way in which business is done in the target's sphere of operations is crucial. Local practices with respect to contracts versus purchase orders, scope of warranties, intellectual property provisions and the like can vary widely from the acquiror's practices. Harmonizing those business practices, while presumably desirable, may simply not be possible if the target is to sustain its customer base and revenues.

Assessing the labor and employment practices in the new country will be important, as will be analyzing the litigation profiles of the countries in which the target operates. While it was once safe to assume that the U.S. was the most litigious of all potential locations in which to do business, other countries are sadly catching up.

Finally, the intricacies of local taxation and currency regulations can dramatically impact the attractiveness of the transaction from a financial point of view.

Involve The Tax Team Early

One of the common mistakes in the acquisition process is to conduct extensive discussions relating to the transaction structure without first seeking the input of tax advisors. If tax consultants are brought into the process late in the day, they may identify significant tax issues or opportunities, but the ability to negotiate measures to deal with them advantageously can be hamstrung if the parties are already locked in on a promised transaction structure. It is a good practice for the CEO to insist that the company's tax advisors be involved as early as the Letter of Intent stage when the rough shape of the transaction is beginning to take place. The tax team should weigh in as necessary throughout the process, and particularly at the conclusion of due diligence.

Thoughtfully Time The Negotiation Of Issues Relating To Senior Management Retention

In order to reap the desired value of an acquisition, it is often necessary to retain key members of senior management. The timing of these discussions is important. Introducing them too early in the process can risk derailing the overall transaction. Moreover, in public company negotiation settings, early negotiations about the compensation arrangements of continuing managers can create unhelpful conflicts that undermine the perceived integrity of the process.

Have A Clear Plan For Compensation And Retention Of Key Executives And Sales Staff

People run businesses, and people make sales. While no one is irreplaceable, in the months following an acquisition, certain employees will have outsized value in terms of retaining key customers, know-how, supplier relationships and the like. Intelligent CEOs work hard to understand who these players are, what makes them "tick," and how they can be retained and motivated after the closing.

Money is not always the sole answer to effective retention. Key executives or sales staff may also value their independence, their ability to participate in and influence the combined enterprise, and other "social" factors that should be considered when designing retention efforts. Similarly, if the compensation being paid to key officers will be dramatically different in form or amount under the acquiror's system, efforts to mitigate any adverse impact must be considered.

When key employees are "cashing out" a significant equity stake, maintaining their energy and attention may be difficult over the long run. Decisions must be made as to whether dissipation of the efforts of these individuals and/or their eventual departure will adversely affect the value of the acquired enterprise. Retention or stay packages can go a part of the way towards assuring that necessary team members remain, as can be new challenges in the combined organization, but succession planning should also be undertaken if long-term retention is unlikely.

Management interviews can be helpful in identifying candidates for succession, and the acquiror should look within its own organization for individuals that can be redeployed into the management of the target.

Use The Due Diligence Process As The Foundation For Integration

Experienced acquirors understand that planning for effective integration begins long before the closing. The negotiation and pre-purchase investigation will identify areas that must be addressed immediately, as well as others that can be tackled over time. Where competitive and antitrust concerns are not operative, the two management teams can begin having joint discussions about how they will function following the closing. In other cases, where one competitor is acquiring another or antitrust or other regulatory concerns prevent such sessions, planning can still occur, although care must be taken to assure that the acquiror is not beginning to control the operations of the target before the closing, resulting in potential legal and regulatory exposure.

In order for the due diligence and investigation processes to effectively aid the eventual integration process, key line functions should be involved in the planning and it is often helpful if they engage their counterparts at the target in that effort.

A written integration plan and time table should be developed and periodically updated. Formulating the right integration team is equally important. Appointing an integration "champion" in key functional areas can be an effective tactic. These individuals must be experienced in effecting and managing change and building relationships and should possess strong problem-solving skills.

The importance of successful integration cannot be overstated. Poor integration can (and often does) destroy whatever value potential is otherwise created by a strong acquisition. While an M&A transaction can be implemented by a small core team of M&A professionals, integrating an acquired operation will require the efforts of broader business teams on both sides of the transaction. The individual responsible for operating the combined business following the closing should "own" the integration process. Personnel from the target, as well as personnel from the acquiror, should be involved in the acquisition integration process. Populating the team with individuals with an in-depth knowledge of the operations of the acquired company, its personnel and customer base, can alleviate unpleasant surprises which would otherwise result from top-down decision making by the acquired parties.

During the integration process, it will be important to avoid the "conqueror" mentality that often poisons the success of business combinations. If the executives and staff of the acquired company feel like they have been colonized, resentments will develop, and departures can be predicted. An announced policy of adopting "best practices" from the each party to the combination is not just smart business, it can aid in the successful combination of the two teams.

Re-Examine And Validate Your Original Justification For The Deal

In disciplined organizations, the decision to pursue an acquisition will come only after a thorough examination of the financial performance and attributes of the target and a robust analysis of the purchase price that should be paid. Strategic considerations will be well thought-out and enunciated. All of this is often embodied in formal documentation in which senior management, including the CEO, signs off on the transaction. In some cases, the transaction is presented to the Board of Directors for approval. All of this typically occurs at the front end of the transaction.

In a surprising number of cases, the "business case" for doing a deal is never again re-examined in a formal and disciplined way, even when the due diligence investigation has identified risks or other issues that will potentially affect the target's post-closing performance.

It is advisable for the acquiror to methodically re-examine the business case for pursuing the transaction in light of the information learned throughout the negotiation and due diligence process. If the financial results are unlikely to be as strong as had been thought, or if the target presents greater risks, valuation models should be re-examined and sensitivity analysis should be considered. While "re-trading" the purchase price is something that most CEOs are loathe to do, extreme cases may require it. In other cases, when due diligence findings severely undermine the business case, a wise CEO will make a clear-eyed re-evaluation of his initial decision to proceed with the transaction, terminate discussions, and move on to the next opportunity.

Use of independent, outside resources to independently check the work of the deal team can be helpful in some cases.

Test The Economics

It is not uncommon for acquirors to evaluate the economics of a transaction solely by reference to projected increases in revenues and earnings and by "synergies" in the form of cost reductions. While all of these are important metrics, it is also important to examine the transaction within the framework of return on invested capital. If you are acquiring a business at a price that is not likely to provide a return on investment capital commensurate with the organization's goals, expectations, and stand-alone performance, the transaction may advance the company's strategy and even increase its revenues and profits in absolute terms, but to do so at a price that is dilutive to the acquiror's equity holders.

Establishing appropriate return on invested capital targets is particularly important for serial acquirors that otherwise might find themselves on a treadmill of making acquisitions that build the size of the company, without building value for shareholders.

Be Careful About The Messages That You Send

One of the most important attributes that strong CEOs offer to their organizations is their enthusiasm (and their capacity to impart that enthusiasm) throughout the ranks. The CEO's ability to bring about organizational alignment is crucial to the success of any business. In an acquisition context, however, these dynamics can be unintentionally dangerous.

A wise CEO will work to create an environment in which members of the transaction team are free to raise for discussion and consideration problems that merit re-thinking the transaction structure, shape, purchase price or advisability. That is not to say that the CEO should tolerate unhelpful passive-aggressive behavior from an executive or advisor with their own "agenda." However, assuring that valid concerns are tabled for consideration is important. The CEO (or other manager leading the transaction) should be careful not to send a message that problems are simply not a welcome topic. This holds true for outside advisors such as investment bankers and lawyers as well. They should be given "permission" to raise, directly with the CEO if necessary, significant issues or concerns.

Ask: "What Is It That We Don't Know?"

Even the most thorough due diligence investigation will not be perfect. At the end of the investigation, there usually will be some unknowns. While "unknown unknowns" cannot be identified or quantified, there may be some uncertainties that *are* identifiable. It may be appropriate to deal with these issues as a matter of risk management within the transaction structure, or in other cases, dealing with them in the integration process will be appropriate. Looking over the horizon prior for uncertainties can be an important last step in ensuring success.

Some Of The Best Deals Are The Ones You Don't Do

M&A transactions take on a life of their own. The efforts of dozens of executives, employees and professionals are aligned around promptly completing a transaction defined to be important to both parties. Time and money are spent in significant quantities. All of this can create a real inertia that pushes a transaction toward closing.

Experienced CEOs are aware of this inertia and will examine the findings of the transaction team and their own "gut" to make a clear-eyed decision to decline to close a deal that does not make sense. Terminating a transaction, particularly one that has proceeded well toward conclusion at significant expense, requires courage. Yet, the business literature is replete with case studies were walking away from a deal proved to be the wisest course of action.

Conclusion

Effective leadership and coordination of team activity is important to virtually all large-scale business activity, and certainly no less important in managing an M&A transaction. Designing the process with the sole goal of "getting to the right answer" is within the unique province of the CEO.

About Frank M. Placenti

Frank Placenti serves as the chair of Squire Sanders' corporate finance and governance practice, and is nationally recognized for his work in corporate governance and mergers and acquisitions. Placenti has more than thirty years' experience in mergers and acquisitions, private equity, corporate governance, securities law, antitakeover and shareholder relations issues. He has represented public companies, private equity firms, portfolio companies and brokers/dealers in capital formation, securities and corporate law, regulatory compliance, recapitalizations, and mergers and acquisitions.

Placenti is listed in the 2006 to 2012 editions of Best Lawyers in America, the 2003 to 2012 editions of Chambers USA: America's Leading Lawyers for Business and is a multi-year member of the Lawdragon 500, an acknowledgment given to the top 500 lawyers in America. He was recommended in Arizona for corporate matters and mergers and acquisitions by PLC Which Lawyer? Yearbook 2009 and is listed in the PLC Cross-Border Mergers and Acquisitions Handbook 2008/2009. Each year since 2007, Placenti has been selected by his peers to appear in Southwest Super Lawyers, a distinction awarded to the top five percent of lawyers in the region. Frank also serves as vice chair of the Corporate Governance Committee of the American Bar Association and as the chair of its Shareholder and Investor Relations Subcommittee.

Placenti is a member of Greater Phoenix Leadership and serves as immediate past chair of the Phoenix Children's Hospital Foundation Board of Directors. He formerly served as the chair of the Board of Directors of the Boys and Girls Clubs of Metropolitan Phoenix, as chair of the Phoenix Chamber of Commerce, as a member of the Board of Directors of the Herberger Theater Company and as a member of the Board of Trustees of the Arizona Science Center.

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