"So You've Decided To Buy A Company !?!"

Lessons Learned from the Acquisitions Fray – Or "Why You Can Trust an I-Banker…. To Be An I-Banker"

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Introduction

So you've decided to buy a company ! Sag Harbor Group and I have been down this path at least two dozen times, and we say, "Good luck to you!" We are happy to help out, but you will have to pay careful attention to the following cautionary tales and signposts.

Think Twice. The very first favor you can do for yourself may be to think "a hundred times again," as the Chinese saying goes. According to the financial literature, and our own published research,[1] this is one of capitalism's most remarkably consistent screw-ups, right up there with making bank loans to developing countries, letting CEOs design their own rewards packages, and relying on "independent" auditors who are also seeking lucrative consulting assignments from management.

The basic fact is that at least half of all publicly-announced acquisitions don't produce any value at all for the acquiring shareholders -- and the average joint venture or "strategic partnership" does even worse.

Private equity transactions may do slightly better on average, just because they are smaller, which helps to solve some post-merger integration problems. On the other hand, private equity deals have problems of their own – such as undisclosed financial or intellectual property problems; founder/entrepreneurs who are constitutionally incapable of sharing power and getting along with others, or have a propensity to "take the money and run;" employees who have grown used to the freedoms associated with swimming in a very small pond; senior managers who can't agree on who reports to whom; customers that miss the personality and independence of the small company; and so on….

The beginning of wisdom in this area, therefore, is that acquisitions are marriages. Or better yet, remarriages. When you grow by acquisition, you are stepping into someone else's warm shoes, and they may not fit.

To succeed, acquisitions have to be approached no less carefully than the most important relationships that we know, with at least as much careful preparation about the values and mutual interests of the parties, the romantic niceties of courtship and post-courtship, the need to know all the best friends, worst enemies, and parents, and the need for soul-searching discussions of future plans and dreams.

Unfortunately, just as in the case of most marriages, this degree of upfront care and forethought is very rare. There is a tendency for deals to turn into "hot dates,"

with a momentum of their own, and with concerns about the morning after brushed aside in the rush to consummation. Even worse, unlike marriages, there is often an army of attendants – investment bankers, lawyers, accountants, consultants – who may want to see deals done, at highly-inflated values, for all kinds of reasons that have nothing to do with their real synergies.

Not surprisingly, therefore, like many marriages, most acquisitions are ill-considered, short-lived, and very costly for the parties concerned. They end badly, accompanied by damaging legal battles, psychic trauma, and bad memories that last lifetimes.

So you need to know, acquirer or acquired, that is dangerous ground that you are treading. You have to be wary. You have to anticipate what can go wrong as well as the glittering upside. You have to allow for those possibilities in your post-merger valuations, and prepare for them in your corporate "pre-nuptial" agreements. You have to prepare for the post-nuptial phase by placing as much emphasis on relationships, team building, trust, and people skills as on raw analytics, term sheets, NPVs, deal structure, and negotiating tactics during the formative period.

In other words, an acquisition is a social relationship, not a thing. So this is not a technical exercise. If you are really going to go through with this – and we are serious when we advise you to consider and consider again -- you will quickly discover that the ability to anticipate a wide variety of boring, "practical" problems of acquiring and integrating another company is at least as important as any fancy valuations, deal structures, organization plans, or theoretical synergies that you might dream up.

Of course, acquisitions are not monogamous. And, indeed, some companies like GE and Cisco seem to have gotten better at them, over time, establishing track records of successful growth-by-acquisition. While serial remarriage may be regarded by our society as a sign of failure, serial acquisition appears to be at least one sign of success. The good news, then, is that acquiring companies is a skill that can be developed. That's one thing that we're going to try to help you do.

First Things First

SO someone has come to you with "a great idea for an company that we really ought to buy." Or one of your CEO's golfing buddies has suggested that maybe your two companies should "get together." Now this matter is in your lap. What are the some of the key things that you need to watch out for?

The subject is complex; there is much controversy. However, as usual, some things can be said.

1. Put One Person in Charge – Not the CEO

This seems elementary, but there are in fact many companies that simply cannot decide who is running the acquisition process, who is managing particular deals, or who has authority to "say yes or no" when it comes down to negotiation and valuation. The result is confusion, frustration, wasted time, disappointment. If a company's VP of Business Development does not have authority to negotiate in the name of the CEO, the company needs to find a new VP of Business Development.

All CEOs like to believe that they are intuitive strategists, and that they are this person. Until cloning becomes legal, there is only one Jack Welch. And even he made multi-billion dollar Honeywells.

2. Retain Excellent Outside Counsel

This is another basic requirement, but, surprisingly enough, many acquirers overlook it. There's simply no substitute for having highly experienced outside legal counsel that has great experience in private equity deals, as well as related fields like management incentives and retention, intellectual property, and securitization. Ideally, you want to find a local firm that just does this for a living. You should not rely on the general-purpose corporate legal counsel. Be warned – you cannot underestimate the value of having outstanding legal counsel on your team. Also be warned – if you want to develop a strong relationship with the prospective target, you must not let legal counsel run the negotiation – very few lawyers are capable of producing much beyond "win/lose"'/zero-sum negotiations.

3. "One-Offs'" vs. Context -- The Role of Acquisition Screening

The next rule is – there's no such thing as an "absolutely good" acquisition or venture candidate. Remember the two economists' greeting: "How's your wife?" "Compared to what?" No matter how brilliant the notion that you've been handed, someone – the CEO, the board, a leading investor – somewhere down the line will ask you whether you to put this particular deal in context – and where it will lead, compared to the alternatives.

The outer limit here is to do a complete screen of all possible targets in the industry, comparing them against one another on multiple factors, such as

potential market size and growth, competitive strengths, “fit/doability,” and the “quasi-options” value of having already this particular deal. The objective is a “playbook/roadmap” that describes where this acquisition fits into the overall market, and the future development of the company. These screening factors, and the screening process, is much more of an art than a science – it should not become a rigid Procrustean bed. That would stifle creativity. At this point, the key idea to grasp is that at least some thought should go into the following three questions: (1) why this deal and not others? (2) what other deals will this one foreclose? and (3) if we do this deal, what other deals will become possible down the road?

4. Every Discussion is a Negotiation – Plan It Carefully

This is a tricky matter, about which tomes can be written. For the moment we will assume that the target is friendly – e.g., at least in principle, open to the idea of being acquired by you. Your early meetings should focus on establishing the ground rules and a positive atmosphere for further discussions, including a clear understanding about what kinds of information you will share; an idea of who will be handling what kinds of issues on both sides; a sense of the timetable that you are both interested in; whether or not the candidate is actively pursuing other bidders; and how you expect to proceed to a decision.

In a friendly acquisition context, where you want the acquired team to feel like they want to stay, the objective should be to build trust and confidence as anything else at this early stage; you need to make it clear that you are exploring a variety of options, that if you decide to make an offer, you are committed to a “win win” approach to valuation and issues; that, subject to competitive issues, both companies should try to share as much as possible about each other; that you are serious and prepared to move extremely quickly, if the plan turns out to make sense for both companies.

5. “There’s No Such Thing As THE Value.” (Triangulate on It.)

Even for publicly-traded companies, valuation estimates are subject to very large uncertainties -- for example, in cases where SHG was a key advisor, as much as +/- 25 percent in the case of one $5 billion acquisition, +/- 35 percent in the case of another $500 mm acquisition, and +/- 20 percent in the case of another $8 billion acquisition. The fact is that standard DCF/NPV valuations are subject to all kinds of “noise” – uncertainty about mattes like discount rates and terminal value assumptions, on top of uncertainty about forecasting cash flows beyond even one quarter, let alone the 5-10 year forecasts often attempted by many

investment banks. Other valuation methods, like "reference multiples," "make-buy" analysis, and "strategic options/ upside" analysis, are often just as flaky.

On the other hand, as usual, ***something*** can be said about value. In most cases the use of several of these methods **at once** permits us to triangulate on a reasonable range of value for an offer. Beyond that, the precise deal terms usually comes down to negotiating skills, the egos of the dealmakers involved, and intangibles like the question of whether or not the retiring CEO will be allowed to keep his corporate jet, or some nifty title variation on "Vice Chairman."

This being the case, the beginning of wisdom here is to understand that there is really no one measure of "value," but many. As we'll see below, there are actually often multiple measures of each one of these value measures for buyers and sellers.

❖ **Reference Multiples.** One baseline that can be helpful is to find any "reference deals" that that recently been done in the same industry or arena, to provide standard value multiples – for example:

- Purchase price (net of assumed debt) relative to (weighted average) revenue;
- Purchase price relative to (weighted average) net income;
- Purchase price relative to (weighted average) cash flow.

Public deals are obviously much larger and less relevant to private equity deals, but it is difficult to get data on a large sample of the latter -- although SHG has often been able to find friendly attorneys or I-bankers willing to help out with such private equity data on an aggregate industry, "no company names" basis.

Such "reference multiples" are intrinsically "soft," in the sense that they tend to vary all over the lot, depend heavily on capital market conditions, and don't necessarily have much pinpoint relevance to your particular deal. On they other hand, because parties can often have access to the same reference data, they can provide a helpful"legitimation" device for defending a particular range of values. They can also be averaged across a wide variety of deals, controlling for individual noise. Compared with detailed DCF/NPV models, they are often relatively easy to come by.

❖ **DCF/NPV.** There are plenty of primers on DCF analysis, so we won't repeat the gory details here – see, for example, the book on basic valuation by McKinsey & Co – written long before it got tangled up in the Enron mess.[2] In the hands of a practiced Excel spreadsheet model-builder – which every VP Business Development should have on his/her staff – this stuff can get pretty

pseudo-scientific pretty fast, with X discount rates and Y terminal value assumptions and Z competitive scenarios.

- As inputs to this valuation process, and as a basic input to financial due diligence as well, early on, you should get the target company to disclose audited financial statements for the last three year. If available, you'd also like to get any projections they may have. (…many small companies don't bother).

Ideally you would also like to build up the overall DCF as the sum of several different piece-parts for the two companies, including:

(1) The "stand-alone" value of the target, assuming it just kept on its current growth path and was acquired by no one else;

(2) The value of any (positive **and** negative) synergies created by the combination of the two companies, which is, in turn, a combo of the value you bring to them and the incremental value they bring to you;

(3) Any "defensive" value that this deal might have, in the sense that your company might lose value if the target fell into a competitor's hands, damaging your own growth plans; [3] be careful here to avoid double counting with respect to the upside synergies; it's not right to include such "opportunity costs" in defensive value;

- **On Choosing the Right Discount Rate.** This is a pet peeve of ours, because we've seen so many pseudo-sophisticated CFOs at major companies -- not to mention financial analysts and I-bankers – who simply do not understand what they are doing in this area. The appropriate discount rate to use for Project X is distinctly NOT the target or acquiring company's own average weighted cost of capital. Nor is it some arbitrary "risk-adjusted" average rate. The appropriate discount rate is the acquiring company's shareholders' opportunity cost of capital. This is usually specified on the assumption (reasonably justified, except in the case of Enron 401k holders) that shareholders can and do diversify away all purely portfolio risk themselves. Thus the only risk that it is appropriate for a potential investor/acquirer to discount for (price) is not the "absolute risk" associated with a project or acquisition, but its **relative portfolio risk** – e.g., that risk that reflects the "incremental riskiness" that Project X adds to a fully diversified portfolio. In statistical terms, with normally distributed variables, this can be reduced to the "covariance" or "beta" of the project with some reference market portfolio. If this covariance is zero, the appropriate rate of discount is a "least risky" rate (for US investors, say, the yield on federal securities for an

equivalent investment horizon.) Note that this covariance can be easily be negative.

- **Strategic Upside/Downside – "Strategic Options" Value.** It is also often helpful just to "dream." The analogy here is to the task of pricing an option, as compared with the pricing of a stock. Especially where we are buying a brand new company with a limited track record, what we are really buying is an "option" on how future possibilities may turn out. The reduction of this basic insight to actual numbers can be quite complex, because, among other things, one always has an option to "delay slightly." Qualitatively, however, this amounts to trying to provide a little specificity to a series of (probability-weighted) "best cases" and "worst cases" that might happen if the acquisition were made – including subsequent deals or technology developments that might be available only if the investment were made. This kind of ""best case/worst case' options analysis can provide the occasion for thought-provoking discussions with the target – or some exposure for the limited amount of thinking that they have really devoted to the future, beyond meeting next week's payroll.

- **Next Best/ Make-Buy Alternatives.** If time permits, we'd also like to develop our own best guess about what the best alternatives paths that we might have to enter this market would cost, if we either bought someone else (assuming there is someone) or built this from the ground up. This can provide the so-called "BATNA" measure -- the best alternative to a negotiated solution. Naturally if we did a full analysis, we'd like to have a stand-alone value, a synergy value, and a defensive value for the BATNA option as well.

6. So What Do We Do With These Valuations? The Bidding Process. Let's assume that we have done all these valuations for target X, and that we are reasonably sure that X is worth 120 to 130 stand-alone, and 150-180 for all synergies, and 160-200 including defensive value. Furthermore, if we don't buy X, our best alternative has a maximum value (including synergies and defensive value) of 170. Do we start out by bidding 200? Do we at least bid 170, our BATNA? Clearly not – not until we've also done an analysis of the target's BATNA.

For what if it turns out that, perhaps just because they use different discount rates or simply have any number of other different value premises, the target effectively has a BATNA of just 130 – well below ours? If we went forward simply on the strength of our own analysis, without knowing this, we'd face a great risk of overpaying for the deal, compared with what the other party might have accepted.

One of the main objectives of all our valuation analysis and negotiation, then, is to get a clearer idea of *how the other party will be valuing his own alternatives*. In our experience, this is one of the main defects in conventional treatments of acquisition analysis and valuation. It is usually treated as some kind of antiseptic, spreadsheet exercise, rather than as part and parcel of the negotiation process. Not only does this ignore the crucial role that relationships play in making acquisitions successful; it also devotes far too much time and energy to the construction of technical estimates – as if the parties shared the same assumptions about the future, or even the same valuation methodology, and as if there were "one right answer" to the valuation question, rather than an irreducible range of uncertainty that can be bridged only by constructive negotiation.

7. Beware of Relying On Investment Bankers. Some of our best friends are I-Bankers. Occasionally they invite us to their mansions in Westchester County. For reasons that have never entirely clear to us, they also often show up on the same or opposite sides of the table when we have been asked to come in as independent consultants and give our assessment of the acquisition candidates, valuations, or deal structure. They are a sharp-talking lot, as a rule. They tend to know a lot about Wall Street, other deals that have been done in the same market, and the corporate social networks and introductions that, for better or worse, provide the basis for many of the deals that are done. They also have armies of model builders that work all night building elaborate valuation models.

In the right context, this can be useful. There are only two problems. First, investment bankers – unlike consultants – are typically paid as a percentage of the value of the completed transactions that they facilitate – say, 1-5% or more of the transactions value, plus or minus retainers, plus or minus costs. Cynically, this means that they tend to have an incentive to (a) want to see deals done, independent of whether these deals actually will yield synergies; (b) they don't really mind if deals are done at super-rich valuations, because it increases their fees; (c) their pay doesn't depend in the slightest on how deals actually turn out.

Second – and closely related to the first point – investment bankers often don't *really* know that much about the industries their clients are in, or, even, more generally, what competitive strategy is all about, and why acquisitions may or may not realize synergies. They are paid to get transactions done – not to make sure the transactions make sense.

Accordingly, rare it is that an I-banker will tell his client that a prospective deal doesn't make sense – unless there is another even larger deal waiting in the wings. And we often have the sense, when one looks at their valuation models, that we have been invited to dinner and served *pictures* of food.

Of course we are all capable of self-serving behavior. But it is an annoying experience to sit across the table from a senior I-banker at one of the best known Wall Street firms, and hear him advise our client to pay $8 billion for an acquisition that is only worth $4-$5 billion. Thankfully, at the end of the day, in that particular situation, the client chose to listen to our industry expertise, and only paid $5 billion. But in many situations we fear that clients chose to rely on I-Bankers rather blindly, either because they believe they really must understand "M&A" work since they do so much of it, or simply because they value their social networks. No wonder that so many acquisitions have trouble delivering the value paid for them.

The morale of this story is simple – if you'd like to have an honest appraisal of which acquisitions, if any, to make, and whether they are worth the candle, add a good solid independent industry/ strategy consultant to the team. The I-bankers will bristle, but they'll get their fees – if the deals make sense.

Summary – SHG's Role in Corporate Acquisitions

SHG prides itself on having assisted on many acquisitions that have since proved successful. It takes equal pride in having told its clients that several acquisitions they had in mind simply didn't make sense at any price, or that they made since only if the price were < $X. In the acquisitions and ventures arena, we have performed successful assignments in any, or all of, the following roles:

- Acquisition/ Divestiture Candidate Identification and Screening – coming up with bright ideas for potential candidates, and screening them rigorously.

- Acquisition/ Divestiture Valuation – developing solid valuation models, based on the methods discussed above, and a clear sense of value ranges from the perspective of multiple parties to a negotiation.

- Due Diligence – technical economic and legal support during the negotiation phase.

- Negotiation Support. Helping to provide on-going negotiation support, including financial structuring, development of "playbooks" for negotiation conduct, and actual bargaining involvement.

- Post-Merger Integration. Assistance with the harmonization of business unit strategies, skills, organizations and staffs for the combined entities -- helping to realize potential synergies as quickly as possible.

We'd be delighted to work with you on any of these issues, on a standard consulting fee basis, or a success fee basis. Please address all inquiries to Jhenry@sagharbor.com. And good hunting!

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[1] See, for example, Richard Caves and James S. Henry, "Mergers and Bidders' Wealth: Managerial and Strategic Factors," in L.G. Thomas, Ed., The Economics of Corporate Strategy. (Lexington, Ma., Lexington Books, 1986).
[2] Copeland, Koller, and Murrin, Valuation. Measuring and Managing the Value of Companies. (NY: John Wiley, 1991).
[3] Be careful here to avoid double counting with respect to the upside synergies; it's not right to include such "opportunity costs" in defensive value;