How to Plan a Merger

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Once, the most common way to grow a business was to hire talent and expand gradually. Today it's more common to grow by acquiring other firms, and what used to be called "merger mania" is simply business as usual. After all, why grow organically when an acquisition can help you leapfrog into new markets with a fraction of the time and trouble?

If only it were that easy. While mergers and acquisitions — or "M&A" — are popular, they're not always successful. Apart from such well-publicized disasters as the Daimler-Chrysler debacle or Time Warner's failed acquisition of AOL, there have been thousands of smaller mergers where the value of the acquired firm was basically squat within a couple years. In fact, more than 50 percent of all mergers fail.

What differentiates the triumphs from the disasters? Three things: groundwork, negotiation, and execution. In this Crash Course, we'll explain how to lay the foundation for an acquisition by intelligently assessing and evaluating potential acquisition candidates.

Things you will need:

- Sufficient assets (like cash on hand or company-held stock) to make an acquisition. In high-growth markets (like software), expect to pay two to five times the target's yearly revenue. In more traditional markets, expect to pay five to ten times the target's earnings before interest, taxes, and depreciation.
- About three months.
- **War Room:** A lockable conference room with lockable file cabinets — you don't want the proposed acquisition to become public before you're ready to make a deal.
- **An Investment Banker:** Acquisitions are complicated, so you'll need financial expertise to assess whether it's possible to make the acquisition and analyze its upsides and downsides.
- **An Acquisitions Lawyer:** Acquisitions often involve public stock, which is heavily regulated. Counsel can ensure that you don't reveal something that could muff the deal or, worse, land you in jail.
- **Modesty:** It's very easy to rationalize bad decision-making with the desire to be a big shot who gobbles up other companies. Before you begin an acquisition, make sure your ego isn't in the driver's seat.

step 1

Determine Whether an Acquisition Makes Sense for Your Firm

Goal: Formulate a clear vision of your company's direction and how an acquisition can support your strategy.

M&A is not an activity; it's a strategy for growth. When a company decides to acquire another firm, it's deciding that acquisition is a more effective way to expand than the slow process of organic growth. Because of this, the impetus for a merger should emerge naturally from your overall corporate strategy.

Unfortunately, that's not always the case. Sometimes the idea of a merger or acquisition emerges out of opportunity. A competitor has a weak year — why not buy them out for a low price? An internal project flops — why not acquire a startup with a similar product? Such acquisitions almost always go sour, according to Edward Weiss, who was general counsel for Group 1 Software when it acquired several firms and was itself later acquired by Pitney Bowes. "An acquisition without a strategy is like impulse shopping," he says. "You always end up with something you neither want nor need."

That's why you need a well-defined corporate strategy. It allows you to cast aside any deal that doesn't move the strategy forward, even if it looks incredibly attractive. "It's not about growing for growth's sake; it's about building a viable company," Weiss says.

Nitty Gritty

The Five Strategic Tactics Behind M&A Activity

Within any corporate strategy, there are five tactical reasons to acquire another company. Most acquisitions combine one or more of these:

Tactic	Example	Why It Works	What Can Go Wrong
Grow market share quickly	Synovus grew to become a $4 billion holding company by acquiring dozens of banking institutions throughout the southeastern United States.	Acquiring a firm can build your finances faster than just growing your firm organically.	If the acquisition goes sour, revenue and profit can dry up faster than a drainage ditch in Phoenix.
Improve utilization of cash on hand	Microsoft had so much cash in the late '90s that investors demanded the firm	Investors think that money sitting in a money-market	Investors might prefer that you up the dividend or launch a stock buy-back.

	spend some of it on acquiring other businesses.	account is wasted equity.	
Provide additional products for current customers	Cisco, which dominated the market for corporate networking hardware, bought Linksys in order to enter the home networking market.	If they complement your current products, the whole could be greater than the sum of the parts.	If the product hasn't been proven in the marketplace, you could end up with a product nobody wants.
Recruit hard-to-find personnel	IBM acquired PricewaterhouseCoopers to secure a large number of management and technology consultants.	Acquiring talent in one mighty swoop can be easier than running a series of job fairs.	Acquired employees may not be comfortable in the new environment, resulting in an exodus of talent.
Expand into new markets	Sony purchased Columbia Pictures Entertainment, instantly becoming a media giant as well as an electronics giant.	Acquisitions immediately bootstrap you into the new market, without forcing you to build a new business from scratch.	Multiple markets can make it difficult for management to focus on being successful in any one business.

Winnow Down the Possibilities

Goal: Pick the company that best matches your corporate strategy.

Once you've decided that an acquisition strategy is the best way to move your corporate agenda forward, you need to build a list of potential acquisition targets and then winnow them down to the one or two that have the best chance of success.

There are two primary ways to find firms worth acquiring. The first, according to Randy Tinsley, vice president of corporate business development at Synopsys, is to find ideas that bubble up from the bottom of your own firm. Tinsley's company, a $1.1-billion-a-year software firm, has made several dozen acquisitions in the past decade. "Our deals typically start when an engineering manager stumbles across a startup that's doing interesting work in his or her area of expertise," he explains. For example, in 2005, programmers at Synopsys noticed that a group of Armenian engineers were posting insightful comments about abstruse computer-chip design issues on industry forums. The internal buzz about these Armenians

bubbled up to top management, resulting in an acquisition of LEDA Design, the Armenian firm that employed them.

The second way to find candidate firms is to hire a consultant who knows the industry and knows what's available. "Some industry sectors are growing so fast that even big companies and major investors don't always know what's going on in the trenches," says Stephen Einhorn, president of Einhorn Associates, a company that helps chemical and life-science companies find investors. "Having access to an organization with a deep understanding of your target industry is crucial to making strategic investments of any kind." For example, Einhorn recently helped Sherwin-Williams locate, evaluate, and acquire Duron, Inc. and Conco Paints, assisting the largest paint company in the United States expand its sales to architectural contractors.

Once you have your list of companies, winnow them down to the most likely, without going through the effort of a full due diligence. The best way to do this is to create a matrix that allows you to compare the candidates against your strategy (see below). Then bring your team together to discuss the pros and cons of each deal. At the end of this process, you should have an idea of which firm is the best match.

For Example

Sample Comparison Matrix

Here's a simplified comparison matrix for a company whose strategy is to become the industry leader in GPS mapping software:

Requirement	Company A	Company B	Company C
Grow share to 51 percent in our current market	Commands 12 percent.	Commands 3 percent.	Commands 18 percent.
Acquire 15 new engineers for customer service	Has staff of 12 programmers; some may be willing to move to customer service.	Outsources this function. Contracts may be transferable.	Has staff of 25 support engineers, located in Alabama.
Expand into commercial aircraft GPS	Not a participant in this market.	Commands 24 percent of this market.	Not a participant in this market.
Estimated purchase price of less than $250 million	$210 million	$72 million	$158 million
Compatible software environment	Yes (Windows)	No (LINUX)	Mixed (Windows and LINUX)

step 3

Perform Your Due Diligence

Goal: Ensure that the candidate truly matches your strategic goals.

Now that you've winnowed down the field, it's time to dig into the details — before getting involved in discussions with the target's management. That means due diligence, a process that's like competitive research on steroids. Below are the steps you'll need to get it done. For a quick analysis of the numbers you may uncover in your research, see our M&A Quick Analysis Worksheet.

1. Build a target profile. Use Internet research to compile a detailed document that describes the target organization. The portfolio should include news stories, conference proceedings, blog entries, SEC filings, and any other publicly available information on the company, its business, and its personnel.

2. Analyze the data. Corporate acquisitions are complicated, so you'll want to draw upon the expertise of your entire team. The earlier you get the right people involved, the more likely you'll end up with a successful deal. "There are so many different aspects to M&A that it would be very foolish to try to proceed based upon a single perspective," says Doug Brockway, a managing director at Innovation Advisors, an investment bank that provides services to mid-market technology companies. In addition to consulting lawyers and financial experts, talk to HR about the potential for relocations, compensation changes, and layoffs and IT about whether the acquired firm's hardware and software will integrate with your own.

3. Look for roadblocks. You can save yourself a lot of grief down the line if you locate anything now that might cause a problem during the negotiation and execution phases. For example, a lawsuit that's not disclosed in the financial filings is a major cause for concern because you could end up acquiring the liability to make good to the plaintiff. Similarly, a blog entry complaining that the target's CEO tends to blow up at meetings is a warning that you may be subjected to some executive bluster.

4. Decide whether to go forward. You're looking to confirm that the company is a good match and will be successful under your corporate umbrella. "It isn't just about whether that company is right for you; it's also whether you are right for that company," says Jack Cooper, president of JM Cooper & Associates and former CIO at both Bristol-Myers Squibb and Seagram. "For a merger to be successful, your company must have a cultural and technological environment that will allow the acquired firm to survive the merger and grow, rather than simply wither on the vine."

5. Give yourself one last chance to back out. Now that you've run the numbers, it's time to do your emotional due diligence. What is the real reason you want to acquire this company? Is there a vanity factor for the CEO ("I want to be the big shot who bought XYZ") or for the company ("we want to dominate the market")? Are there unrealistic expectations that this deal is the magic solution that will save your company? Behind most failed mergers lurk ego- and

insecurity-driven motivations. If you suspect this is the case, don't be afraid to back out. The cheapest time to correct errors in judgment is now.

Essential Ingredients

Due Diligence Made Easy

Here's are the four sections that should be included in any due-diligence portfolio:

1. The financial data. If the target company is publicly held, retrieve its last 12 10Q reports. Have your team read them, cover to cover, looking for anything out of the ordinary. Was revenue restated? If so, why? Is the brand name listed as a hefty asset? If so, who assessed the value? Is the company being sued or suing someone else? How strong is its case, and what does the lawsuit say about the target firm? In the end, you should know more about the target than a mere investor would.

2. The news profile. In today's wired world every company leaves a trail of news stories. Examine what's been said about the company in the press. Pay particular attention to statements by customers and analysts about the viability of the company and its products. Remember to filter out anything that's clearly from a PR group; focus instead on bylined articles published in reputable magazines, newspapers, and websites.

3. The key employees. Peruse the company website and the Web to discover the 10 most important management and nonmanagement employees. Spend at least half an hour on Google, researching who each person really is and what they're really like. Don't just retrieve their online resum s; find out their hobbies, their interests. And don't forget to do a background check on a service like [[www.intelius.com] [Intelius]]. If there are legal skeletons in any closets, you'd best know now.

4. The corporate culture. Browse the company's website to get a feeling for how they're presenting themselves to the world. Then, to find out what the place is really like, examine the job postings on the recruiting page. The line managers who write those postings want to hire someone useful, not promote the corporate image, so these notices give a snapshot of what really goes on inside. For example, if the corporate mission statement touts customer satisfaction but the descriptions for sales jobs are all about moving product quickly, you can be pretty certain that the customer satisfaction talk is just that — talk.

step 4

Prepare to Make Your Offer

Goal: Meet with the target to decide whether to move forward.

Contact the management of the target firm with the (hopefully) good news. If they've put themselves on the market, they'll probably welcome your interest and invite you to their headquarters to find out more.

If your interest is likely to be a surprise, though, diplomacy is in order. Contact the CEO of the target firm and ask for a one-on-one meeting, preferably at a neutral location, like a local restaurant. While the CEO will probably be able to guess what's up, broach the subject carefully, being sure to praise both the firm and its leaders. Ask him to discuss the idea with his team and his investors. Then set up a broader meeting, at the target's headquarters, to discuss the idea with the CEO's management team.

When you get to the target's headquarters, you'll need to do two things. First, lay the groundwork for future negotiations by presenting a positive and upbeat view of your company. This stage of the process is like the beginning of a courtship; you want to put your best foot forward — not insert it in your mouth. Second, you want to confirm that the company is the attractive acquisition your due diligence has indicated. When you meet with management, dig into the details of their business. Get the answers to any questions that remained unanswered during the previous step.

Most importantly, assess their enthusiasm for what they have to offer. "There are two things I look for when a company tells their story," says Mitchell Kertzman, venture capitalist at Hummer Winblad Venture Partners and former CEO of Sybase, Powersoft, and Liberate Technologies. "The first thing is enthusiasm; I want to see somebody who has the same kind of passion and commitment that Richard Dreyfuss had in 'Close Encounters of the Third Kind.' The second thing is candor. I want to know whether they can be trusted to reveal things that might not be in their interests for me to know — before I get out my checkbook." (Note: Kertzman previously sat on the board of directors of CNET, the parent company of BNET.)

Checklist

Questions to Answer Before You Make an Offer

There are six questions that must be answered to your satisfaction before you even think about closing a deal. You can't just blurt out these questions during meetings with the target's management, but all your research and interviews must drive toward answering them:

1. Are the numbers real? You've examined the target's financials, of course, but you should push to find out if there are any inconsistencies. For example, if revenues spiked up at the end of the fiscal year, were they dumping inventory on customers to make the numbers look good?

2. Are the products real? Some industries, notably high tech, are so riddled with hype that it's not always clear what's real and what's just a concept. If the product is released, check with customers to be sure it really works. If it's pre-release, have your own experts poke and prod to be sure it's what the company says it is.

3. What's the quality of the management? You should have a good feeling about the competence of the target's management team, especially if you're expecting to keep them onboard. Ask them how they'd handle different situations and then ask yourself if you would want to work for them. If not, there may be conflict ahead.

4. What’s the quality of the employees? Since you’re acquiring people as well as product, be sure that the people who know how to build, upgrade, and support the product are still onboard. You don’t want to find out after the acquisition that the real brains behind the organization left a year earlier.

5. How well do they match your corporate culture? This is subjective but extremely important. Your existing organization will have to work, day in and day out, with the new folks. Is that going to seem natural — or is it going to be a forced fit?

6. How well do they match your corporate strategy? Sure, you went through the analysis in the earlier steps, but this is your last chance to revisit your logic. Does it still seem like a good idea? If so, then it’s time to enter the negotiation phase.

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