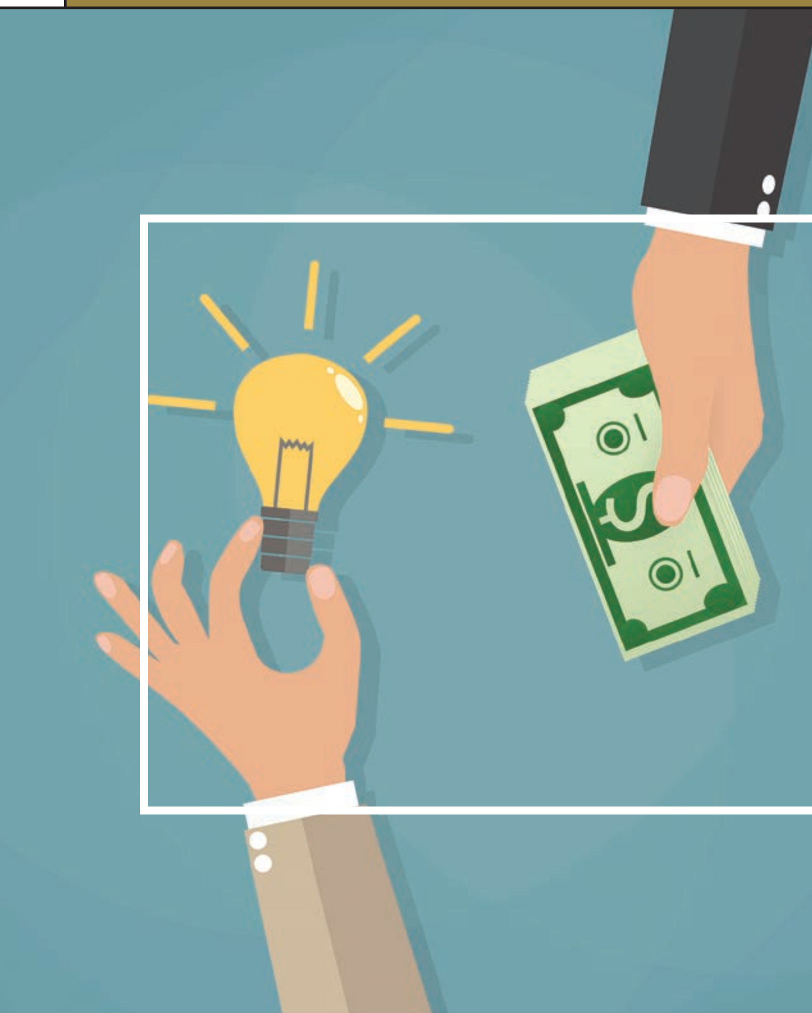
Merger & Acquisition Focus



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Buy your disruptor — and turn a threat into an opportunity

Passport to M&A success
Selling to an international buyer

How a merger puts the spotlight on your CFO

Ask the Advisor

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Buy your disruptor — and turn a threat into an opportunity

In the corporate world, a disruptor typically is a start-up company whose business model is built on upending the status quo. A disruptor's success can potentially make an industry's established players yesterday's news. If your company is being rocked by new, disruptive competition, you might want to consider an increasingly common strategy: Buy your disruptor.

Identify the threat

What do disruptors look like? Cloud computing service providers, for example, currently represent a serious challenge to many traditional database hardware providers. Ride-share companies like Uber and Lyft threaten taxicab and limousine providers. Online-only clothing retailers are, in many cases, undermining apparel retailers anchored to costly storefront-based business models.

If these threats sound familiar (not to mention scary), you may want to take action and buy a disruptor. However, it's important to know that, to succeed, such acquisitions must be more than defensive moves. After all, if your company is out of touch with its customers or suffers from other fundamental problems, an acquisition alone won't save you. What purchasing potentially threatening competition can provide is the resources to adapt to changing market conditions.

Take notes

One aggressive buyer of potential disruptors is Google, which looks for young companies that could challenge its dominance in any area and snaps them up. Google's practice is successful because it incorporates the acquired start-ups' strongest talents into its own operations. According to *TIME* magazine, Google has employed more than 220 start-up founders from acquisitions it made between 2006 and 2014.

Here's another example. Many traditional insurance companies run the risk of losing customers to businesses with fully automated recordkeeping and client management services. So they've tried to boost their digitization efforts by buying start-ups. Nearly half the insurance company respondents to a 2017 survey by Willis Towers Watson said they plan to make a purchase in the next three years to gain access to digital technologies.

Look for advantages

It's clear what your company might want from buying a disruptor. But what might a disruptor want from you? One major motivation is capital. Given the aggressive expansion and promotion that their business models require, start-ups tend to be undercapitalized and their expenses often outpace their revenues. Uber, for example, reportedly lost roughly $3 billion in 2016. If your company has substantial reserves, a disruptor could leap at the chance to be acquired. In fact, many disruptors set out with the explicit intention of selling to market leaders.

But even if you find an eager seller, plenty of pitfalls await — starting with cultural discrepancies. Employees from entrepreneurial start-ups are notorious for resisting the established culture of their company's new owner. Lack of flexibility also hurts buyers that fail to adopt their acquisitions' successful business practices. (See "Managing the personalities" at right.)

To improve the odds that your disruptor deal succeeds, consider these models:

Keep the company separate. Here, you make your acquisition a stand-alone subsidiary and provide it with capital and strategic guidance but minimize interference in its day-to-day decision-making and operations.

Make it first among equals. You might turn the disruptor into a division "competing" with established divisions — with the expectation that it will eventually surpass them. For example, a database company might run its new cloud-computing unit under the same overarching management structure as its older hardware sales division.

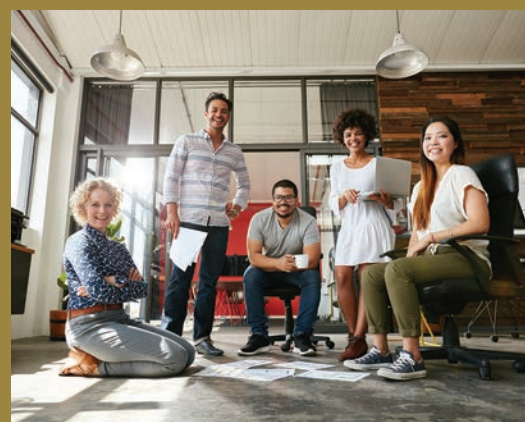
Integrate it completely. This model is easier to adopt if you're Google or a similar market giant. But if your company is using outdated technology and following R&D, marketing and other practices that no longer seem relevant, you probably need to consider a complete overhaul. New talent working within your organization and generating fresh ideas can help you do that.

Expect change

If you've been running a business for any length of time, you know that nothing's more permanent than change. Sector leaders can't assume they'll stay on top forever — or even for very long. Buying a disruptor is one way to address this challenge. ■

Managing the personalities

Incorporating a start-up into an established business can be perilous from a cultural standpoint. It's very common for some employees to think their counterparts are stodgy and out of touch or, conversely, arrogant and untried.



Start-ups tend to attract assertive, ambitious people who may feel stifled in a more traditional work setting. The risk is that these people will jump ship before the M&A deal closes and perhaps even start their own businesses to compete with your company. However, there's also some danger in keeping such employees on with little oversight. Start-up staffers may be accustomed to constant growth (which can lead to cutting corners) and aggressive sales tactics (which can backfire badly). So, though you don't want to hinder creativity, you may need to rein in potentially risky behaviors and practices.

Establish liaison teams from your company and the seller's early in your deal's integration process, with regular input from both management groups. The more conversations employees have with each other, the better their chances of finding common ground and staying there.

Passport to M&A success

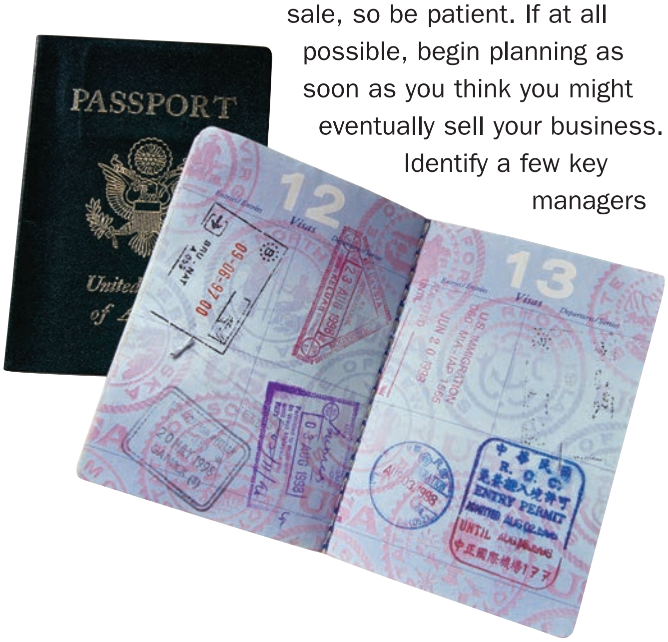
SELLING TO AN INTERNATIONAL BUYER

Foreign buyers of U.S. companies announced a record-breaking $491 billion in deals in 2016. If you've considered putting out the international "For Sale" sign in 2017, you'll likely find a fertile environment. But it's important to understand that selling to a foreign company is different from selling to a U.S.-based one. Here's what you need to do to prepare.

Cultural stake

Before marketing your business overseas, consider whether its culture can support an acquisition by a non-U.S. company and whether your business is likely to thrive under such ownership. Even if a foreign buyer regards it as an advantageous acquisition, a bad sale could negatively affect your valued employees, and if you maintain a stake in the business after it's sold — you as well. Understand also that foreign buyers are typically interested in companies with a minimum annual revenue base that justifies the increased risks and expenses related to international deals.

Preparing for an international deal can take longer than getting your company ready for a domestic sale, so be patient. If at all possible, begin planning as soon as you think you might eventually sell your business. Identify a few key managers who can be trusted to spearhead the preparation and valuation process.



International value

To obtain an accurate valuation of your company, look for an expert with international experience. If you have a specific buyer in mind, you may want to hire a business valuator based in the buyer's country, or at the very least someone with knowledge of the country's financial regulations and customs.

Foreign buyers often consider intangible assets the most valuable pieces of a deal, so ensure that you fully own the rights to your IP.

Financial statements should be prepared according to Generally Accepted Accounting Principles (GAAP). Be ready to present audited financial statements from the past several years. You don't, however, need to worry about reconciling the differences between domestic GAAP and International Financial Reporting Standards. That's the buyer's responsibility.

You can make your business easier to appraise by eliminating discretionary expenses as much — and as far in advance of the sale — as possible. A prospective buyer doesn't want a target that frequently readjusts its EBITDA (earnings before interest, taxes, depreciation and amortization) for discretionary expenses. And if your company has substantial in-process research and development expenditures, keep supplementary accounts that detail the expenses.

If you've been expensing your fixed assets, you'll likely need to start capitalizing them instead.

Doing so will make your earnings from one reporting period to the next appear less volatile and enhance your reported cash flows relative to capital expenditures.

Ready for review

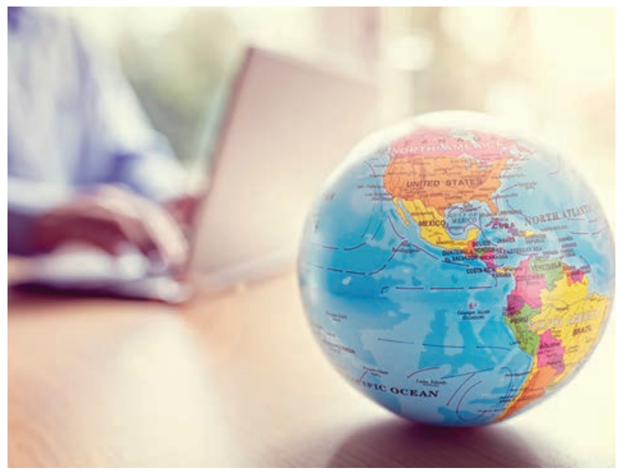
Once you reach the due diligence stage, provide your prospective buyer with a streamlined, easy-to-read summary of your company's assets and expenses. You'll also want to give the buyer detailed information about your business processes — including internal controls, information technology, compensation plans and operating manuals for specific products.

All of your properties should be carefully outlined and annotated. This includes intellectual property, such as licenses and trademarks. Foreign buyers often consider intangible assets the most valuable pieces of any deal, so ensure that you fully own the rights to all of your intellectual property.

You can make it easy for buyers to access and review your company's data off-site by uploading it to a secure Internet-based document storage site. Among other advantages, this gives foreign buyers a chance to get to know your company before they conduct a time-consuming in-person review.

Be prepared

It's hard enough to execute a domestic M&A successfully. Having an international buyer that must adhere to different regulatory and legal requirements makes the process that much more complicated. Make sure you've prepared for sale with these different requirements in mind. ■



How a merger puts the spotlight on your CFO

Whether you're buying or selling a company, your chief financial officer (CFO) is often your deal's linchpin. An M&A's success or failure — from deal negotiations to postmerger integration — is inextricably linked to the CFO's performance. But if your CFO is like most, he or she already has more than enough to do without adding time-consuming M&A responsibilities. So it's important to consider how you can maximize the time and talents of your CFO while minimizing possible distractions.

Plateful of duties

Owners, CEOs or boards of directors usually make the final decisions about mergers, from deciding to pursue a deal to approving price and terms. A CFO, on the other hand, should act as a nexus of M&A planning, negotiation and execution. In some cases CFOs play a strategic role; however, in most their key roles include the following duties:

Evaluating viability. Buy-side CFOs assess the risk of a potential deal, its potential costs and the

possible share price impact. Sell-side CFOs evaluate competing bids and run analyses of potential deals.

Finding the money. If an acquisition requires outside financing or liquidation of the selling company's assets to raise capital, the CFO is responsible.

Managing due diligence. CFOs usually supervise due diligence efforts — preparing for scrutiny on the sell-side and conducting financial, legal and operational review on the buy-side.

Integrating the companies. Integration encompasses merger of financial, human resources, IT and other functions — and there's plenty of room for error at this stage. CFOs may need to oversee everything from severance packages to real estate obligations.

Acting as counterweight

One of a CFO's critical duties is to perform a "reality check" on management's strategic assumptions. A CFO informs executives about whether a deal is sound from a financial perspective or whether it appears to be too costly or could potentially reduce return on equity. Sometimes, it's difficult to dissuade enthusiastic owners and CEOs, but if a deal has the potential to cause harm, CFOs must make the argument succinctly and persuasively.

A great deal of analysis typically goes into such positions. CFOs should map out worst-case scenarios. They might, for example, test various client relationship, supply chain, employee retention and morale factors. If required to come up with deal financing, CFOs should compare loan costs and possibly find alternative financing options.

Measuring performance

Once a deal is underway, CFOs normally act as coordinators, making sure that everyone knows what's going on and what they're supposed to be doing. If a snag develops during negotiations, CFOs usually untangle them.

This job is made easier by setting clear goals. CFOs should choose performance metrics carefully at the beginning of the process so that the deal runs according to schedule. Proper metrics also enable buyers to judge whether an acquisition is performing to expectations. If a decision made before the deal closed doesn't deliver expected results — such as to reduce headcount or discontinue products — the CFO usually is on the hook.

Juggling duties

It should be clear that CFOs carry a heavy load during the typical M&A transaction. How should one person be expected to fulfill all of these duties *and* perform their usual job as head of your company's financial function?

Consider temporarily shifting your CFO's duties so that he or she can concentrate exclusively on deal negotiations. You might, for instance, assign deputies to run day-to-day financial operations or shift some of the work to department managers. Your CEO could assume additional management tasks. Also encourage your CFO to delegate as appropriate. While this individual needs access to pertinent details, your CFO probably won't have time to micromanage areas such as IT reconciliation when there's so much else at stake.

Protect your key player

Probably no other executive's performance is so central to your transaction's success as your CFO's, so it's essential that he or she understand what will be expected. It's also critical that you support and protect this vital player.

Ask the Advisor

Q. Should I consider a long-term acquisition?

A: Many M&A deals are completed in a matter of months, but some involve slower transfers of ownership. Why would you choose to draw out what can be a very demanding process? In general, long-term acquisitions are attractive to owners who don't want to relinquish control just yet, or buyers who want to prolong the departure of key employees. However, these deals require considerable patience and the relationship between the buyer and seller must be strong.

Two types

There are a couple of ways to execute a long-term acquisition. If the seller is a public company, a buyer can accumulate shares until it becomes majority owner, and then make a tender offer for the remaining shares.

A long-term deal can enable the ownership transition to proceed at a more manageable pace.

If, on the other hand, the selling business is privately held, it might sell a minority stake to a potential long-term buyer. This initiates a tryout period to assess the two companies' compatibility. The parties may sign an agreement in which the minority stakeholder has the option to offer a takeover bid after a specified period.

Advantages for sellers

Some companies, particularly those owned by the business's founder, find it hard to give up total control to a buyer. Yet they nevertheless face a selling event, such as the founder's retirement. A long-term deal can enable such a transition to proceed at a more manageable pace.

It also can provide needed capital. The cash infusion from selling a minority stake can be used for improvements such as in hiring, debt reduction, research and development or office expansion — all of which can help grow the company's market share or improve profits.

Benefits for buyers

A minority-stake purchase requires less cash than a full acquisition, helping buyers avoid finding outside deal financing. It's also less risky than a full purchase. Buyers can, for example, push for the company to achieve certain performance objectives before it commits to buying it.

Integration may also be easier because buyers have time to coordinate with sellers to implement changes — an advantage when their IT, accounting or other major systems are dissimilar. Decisions must be made quickly in typical deals. But with a long-term acquisition, the parties can debate and negotiate options, which may improve the deal's long-term prospects.

Taking your time

If you need speed, a full sale may be the better choice. But if you're not ready to sell and have the time, consider a long-term acquisition. ■

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Passing the Business Torch ... One Successful Transaction at a Time

Our Firm:

Everingham & Kerr (E&K) is a regional merger and acquisition advisory firm focused on implementing exit and growth strategies for lower middle market companies. Our client base includes private and publicly owned companies, investor groups, family businesses and entrepreneurs. Since 1988, the firm has successfully completed hundreds of transactions spanning virtually every industry sector.

Our Maxim:

Combining Experience, Teamwork and Persistence to Produce Superior Results.

Our Services:

Sales:

E&K provides representation to sellers of lower middle market companies including sales of entrepreneur and family owned companies as well as divestitures of business units of private and publicly owned companies.

Acquisitions:

E&K assists companies, entrepreneurs and corporate executives develop and execute customized acquisition strategies designed to result in successful transactions.

Transaction Consulting:

In some instances the parties to a transaction locate each other through informal industry or personal channels. These transactions include sales to unrelated third party acquirers, as well as management, family and partner buyouts. E&K is often engaged to structure these transactions and navigate the many issues requiring attention from the initial stages to the consummation of the transaction.

Business Valuations:

E&K provides a full range of valuation services to business owners for personal and corporate affairs. Supporting our belief that all owners should know the “real” value of their business, E&K offers the “Owner’s Planning Valuation”. This is an informal valuation that can be prepared in a cost-effective manner and updated periodically to assist owners with company and personal planning issues.

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