Merger & Acquisition Focus

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Is it time for a spinoff?

Intellectual property:
Get what you're paying for

Taking data privacy seriously
If you don't, your buyer certainly will

Ask the Advisor

Celebrating Over 25 Years

Everingham & Kerr, Inc.

Merger & Acquisition Advisors focused on the Lower Middle Market

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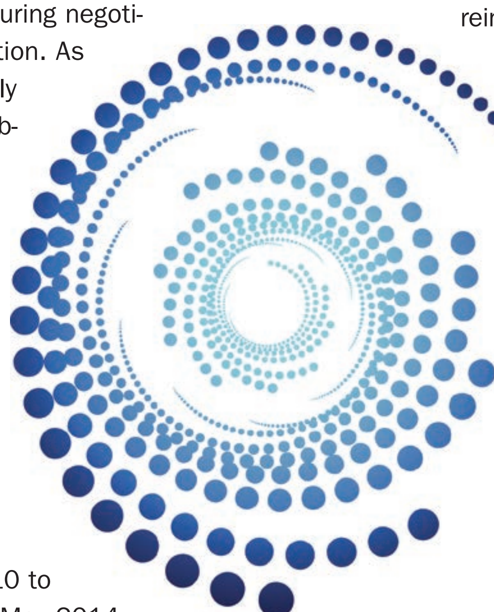
Is it time for a spinoff?

If selling — or spinning off — a division or subsidiary is part of your company's long-term strategic plan, consider taking action soon. Spinoff volume has increased every year so far this decade, and the current market is particularly receptive to spinoff deals.

Of course, spinning off a unit can be a tricky process, requiring finesse during negotiations and postsale integration. As a seller, you need to not only get a good price for your subsidiary, but also minimize any negative impact on your remaining holdings.



Sales are booming

The last few years have been good for spinoff deals. According to law firm Debevoise & Plimpton's *Private Equity Report*, U.S. total volume rose from $17 billion in 2010 to $123 billion in 2013. As of May 2014, 40 spinoffs had been announced, suggesting that this year may match, if not top, 2013.

A company might spin off a unit that's financially strong yet doesn't fit its strategic plans.

Spinoffs generally appeal to companies that wish to avoid the difficulties associated with selling larger and high-performing companies and to accelerate knowledge exchange and postdeal integration. Currently, the pharmaceutical sector is exhibiting such need for speed (and convenience) and is hopping with spinoffs. For example, in early 2014, GlaxoSmithKline sold its cancer treatment business to Novartis, which in turn sold its animal health division to Eli Lilly.

Why do it?

Other factors besides time can affect a company's decision to spin off a division. Some sellers wish to focus on their core business, access capital for reinvestment, or generate greater operational efficiencies. In consolidated industries with limited buyer pools, companies may worry that a full sale will raise red flags with antitrust authorities.

A company might spin off a unit that's financially strong yet doesn't fit its strategic plans. A case in point is Merck, which recently spun off its lucrative consumer products division to Bayer so it could concentrate on developing new drugs.

Standalones and carve-outs

Spinoffs range in complexity depending on the unit being sold. If it's a standalone subsidiary, the spinoff will likely be an easier process. The unit is already legally separate from its parent and probably won't have much overlap with its parent's operations.

More challenging is spinning off an internal division — also known as a "carve-out." Here the seller has to determine which of its employees, clients and product lines will be included in the carved-out division. The seller also must legally extricate the division's assets, debts and liabilities from those of the parent company. In fact, "carve out" is something of a misnomer, since what sellers must do is disentangle the division from the larger organization while attempting to minimize disruption to other units.

Because a company must decide which employees, products and property belong with the selling division, battles over ownership of certain assets are possible. For example, if the carve-out and a unit that's remaining with the parent company both rely on the same exclusive intellectual property, who retains ownership postsale? Such disputes can delay a deal and even reduce the value of the spinoff for the selling company.

Merck's consumer products spinoff was a carve-out deal and required months of internal analyses and negotiations. Even for smaller-scale carve-outs, determining which parts of a company belong to the selling unit can be logistically challenging.

Next steps

If your company is looking to streamline operations and could put the cash from selling a strong division to better use, it's time to consider a spinoff. Be aware, however, of how a spinoff might affect the health of your existing operations. If it seems unlikely that you'll be able to make a clean break with one of your units, you may want to consider other options. ■

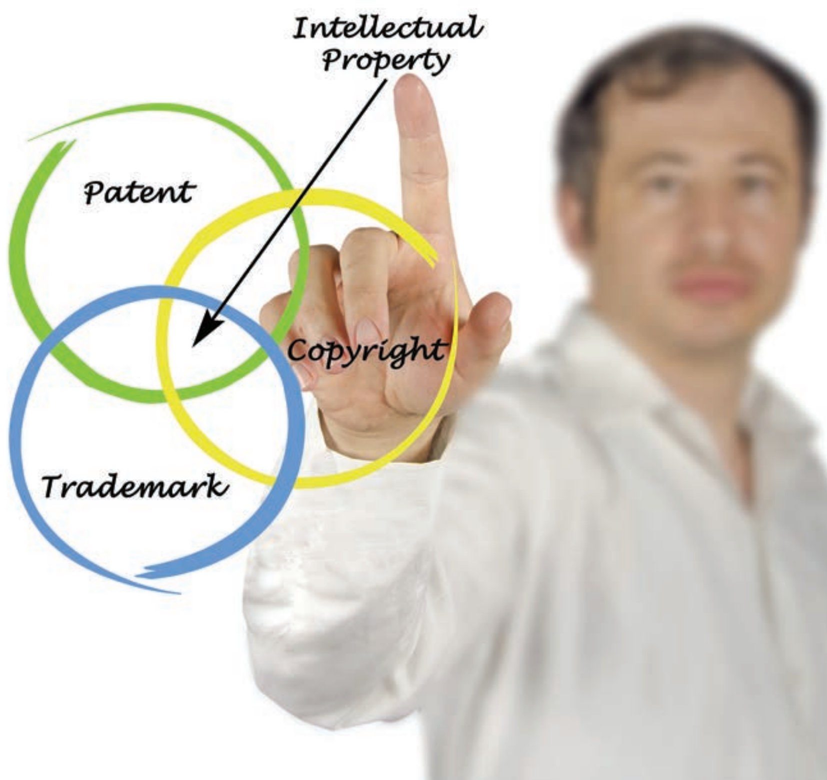
Intellectual property: Get what you're paying for

A large midwestern manufacturer had high hopes for its planned acquisition of a smaller distribution company. Among the target company's assets was proprietary order-tracking software that the buyer hoped to use throughout its organization. But during the due diligence stage, the manufacturer made a startling discovery: The seller's tracking software was owned by the former employee who developed it. The manufacturer reconsidered its offer, deciding that it could find a better acquisition elsewhere.

Intellectual property (IP) plays a significant role in the value of many businesses, yet selling companies aren't always careful to ensure that they actually own their patents, copyrights, trademarks and trade secrets or that licenses are transferable to a new owner. To avoid overpaying for acquisitions, business buyers must thoroughly vet their targets' IP assets and make sure the purchase includes clear title to everything.

Identify property

Begin your research by identifying key technologies, processes and products your target company has developed or uses. Then examine which patents have been issued to it and those for which it has applied. As part of your analysis, determine whether the patents protect key technologies or only minor aspects of them. If the latter, competitors may be able to bypass certain patent protections.



Are any patent applications provisional? If so, you won't yet have patent protection. However, provisional applications can be useful placeholders for future nonprovisional filings. It's also important to learn whether patent applications have been filed in all the countries where the company does business and if any of these foreign applications have expired.

In addition, you'll want documentation proving that all patents' inventors have formally assigned the patent to the company. This can be particularly troublesome if the inventor has since left the company.

Finally, find out what patents the target licenses from third parties. For the merged organization to use these patents, licenses may need to be transferred and royalties may be owed for past or future use.

Check the copyrights

Copyrights harbor similar risks. Companies working with independent contractors may fail to ask developers to sign agreements that release rights to IP on which they've worked. Unless you have this kind of agreement, the work product legally belongs to the contractor, and you may have to pay a fee to use it.

Another concern is copyrighted material the target licenses, particularly computer software. Make sure the proper licenses are transferable for proprietary programs — as well as for trademarks.

Dig up trade secrets

Trade secrets include formulas, practices, processes, designs, instruments, patterns or a combination of information used to gain an advantage over competitors. Determine whether your potential acquisition has employee or contractor secrecy agreements, nondisclosure agreements with potential customers or partners, and licenses with customers that restrict the use of proprietary information. For trade secrets to be enforced by a court, it's vital that the information be kept confidential and access to it be limited.

Also ensure that the company has safeguarded trade secrets that can be accessed on information technology systems. Passwords should be changed whenever a person with access to trade secrets leaves the company.

As part of your analysis, determine whether patents protect key technologies or only minor aspects of them.

Delve into licenses

Licenses come in two forms: those that give your target company access to another company's IP, and out-licenses that the target issues to third parties. Ask the seller several questions about its licenses:

- Do they have favorable terms?
- Are any licenses expiring soon?
- Can the licenses be terminated without cause by the issuing company?
- Have the issuers provided timely updates on licensed information?
- Are the licenses transferable to you as the new owner?

Be sure out-license agreements aren't written so broadly that it will be difficult for you to capitalize on them. This could include unlimited use by a large customer or exclusive arrangements with distributors.

Seek guidance

Depending on your industry and target, there may be other IP assets to consider during due diligence. Your M&A advisors will be instrumental in guiding you through this important part of the acquisition process. ■

Taking data privacy seriously

IF YOU DON'T, YOUR BUYER CERTAINLY WILL

Planning to sell your business? If your company collects and stores even the smallest amount of customer information, you must take data privacy seriously. Companies that aren't fully up to date and compliant with an ever-growing number of data privacy regulations can hit major hurdles during the M&A due diligence process, adversely affecting the sale price.

Securing data is probably already a high priority if your company is an online retailer or belongs to a heavily regulated industry such as banking. But data privacy can be a land mine for businesses that have limited online interactions with customers and are possibly unaware of the regulations that apply to them.

A question of due diligence

During the due diligence stage of an M&A deal, a prospective buyer will want to learn the type of personal information you collect and how you protect it. If your company is at risk of a data breach or

What's "personal information," anyway?

Business owners unfamiliar with data privacy issues may be surprised to discover that even the most innocuous type of information collected is likely considered "personal" and is covered by some regulation.

Anything that could remotely identify a customer should a data breach occur will expose your company to potential lawsuits or fines. Be particularly careful with:

- ❖ Financial data, including bank account, credit card and debit card numbers and expiration dates,
- ❖ Personal identification such as Social Security numbers, dates of birth, spouses' and children's names, marital histories, street addresses, telephone numbers and e-mail addresses, and
- ❖ Site-specific data — for example, online user names and passwords and account information such as customers' previous purchase histories and shipping addresses.

A quick review of your customer interactions will almost certainly disclose you have some — if not all — of these types of information in your databases. If you aren't confident that your data protection practices could stand up to possible regulatory scrutiny, not to mention online hackers, it's time to make data security a priority. Remember that putting rules in place is only part of the solution. You also must train employees and regularly monitor their compliance.

isn't in compliance with state, federal — or even international — regulations, deal negotiation could be delayed until solutions are implemented. In a worst-case scenario, a buyer could call off the deal.

Sellers must disclose to their buyers any complaints or investigations involving data security breaches and the amount of potential liability. If potential liability is substantial, the buyer is likely to ask for compensation with a lower sale price.

Parsing language

To better understand the volume and the nature of the personal information your company collects and how you safeguard it, your buyer will review several documents. These include your company's public statements on data privacy (such as language on your website) and internal written information security programs (WISPs) that describe your company's administrative, technical and physical safeguard procedures.

WISPs are now legally mandated in Massachusetts, and customers in all states are increasingly requesting that the companies they do business with voluntarily put WISPs in place. If your company doesn't have a WISP, a buyer could demand you write one before the deal closes — so it's best to proactively take care of the matter before entering into negotiations.

Regulation menu

Your company may be unaware of the many data security regulations that affect it. These have grown in both number and complexity in recent years and, as noted earlier, are in place at various levels:

Federal. The Federal Trade Commission (FTC) Act empowers the FTC to investigate whether your company's customer data sharing or storing practices are subject to the Health Insurance Portability and Accountability Act (which could apply if your customers share medical information with you) or Children's Online Privacy Protection Act (applicable to information that children or their parents share with your company).

State. The majority of U.S. states have enacted "Baby FTC Acts," statutes that consider any improper sharing of their residents' personal information to be potentially a deceptive practice. Nearly every state also has notification laws mandating that companies disclose any personal information security breaches.

International. If your company has international clients, you may need to comply with the regulations of their home countries. The European Union's (EU's) Data Protection Directive applies to any personal information that EU citizens transfer to locations outside the EU. For example, if your company has a single client in France and keeps any of her personal information, you'll likely have to comply with this directive.

Rule of thumb

Complying with data privacy regulations might seem overwhelming at first. A simple rule of thumb may help: When it comes to your customers, always err on the side of protection. By establishing strong data privacy practices before attempting to sell your company, you can prevent these issues from becoming a deal breaker. Ask your M&A advisors to refer you to information security specialists who can help enhance the value of your business.

Ask the Advisor

Q. Do I need a fairness opinion for my M&A deal?

A. Fairness opinions are a common ingredient in the M&A stew. In the right circumstances, they can enhance a deal's appeal by reassuring stakeholders that the transaction's terms appear to be fair from the perspective of a mutually assigned, "neutral" third party. However, a fairness opinion is just that: one advisor's opinion. Neither party to a deal should consider even the most carefully deliberated opinion as the final word.

Seeking reassurance

Either the buyer or seller can hire a third-party expert (often an investment banker) to review a deal's pricing and terms. After comparing the terms to those in mergers involving similar companies, the expert pronounces whether the deal is "fair" for the client's owners and shareholders.

Whether you need a fairness opinion depends largely on your company's ownership and the ease of the deal. If both companies are privately owned and negotiations have run smoothly, there's probably little need to spend time and money on a fairness opinion.

When you need to vet

However, not all M&As are so simple, and there are plenty of circumstances where a fairness opinion may be called for. For example, if the deal is a hostile takeover, a fairness opinion is all but mandatory for the seller. And public company sellers should consider one if they've received several competing offers. Shareholders could sue if their company doesn't accept what appears to be the most lucrative offer.

Other reasons for getting a fairness opinion include:

Multiple players. Are there several owners or buyers involved, such as private-equity firms or minority shareholders? The more parties at the table, the greater the need to ensure that the deal is equitable for all of them.

Contentious negotiations. Have there been ongoing disagreements among owners about terms and valuations? Conflicts now can easily lead to litigation later. A fairness opinion helps to show that the parties have made a good-faith effort to strike a fair deal.

Company history. Does the buyer have a history of poor financial performance or trouble obtaining financing for acquisitions or integrating them? A fairness opinion could reassure a wary seller.

Knowing its place

Although a fairness opinion can help when a transaction is complicated or contentious, it's neither required by law nor legally binding. If you're worried that you're making a bad strategic decision or that the other party to your deal isn't playing fair, discuss your concerns with your M&A advisors. ■

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Celebrating Over 25 Years

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 over 350 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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