The Issue

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Maximize your company's value to a Strategic Buyer

Avoid price reductions due to unexpected surprises in due diligence

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According to an empirical study done by Bargeron et al (2008)[1], the acquisition price paid by a strategic buyer[2] is higher than the financial buyer[2] due to the synergies to be created by a strategic buyer. Furthermore, that study reported the average deal premium to be 46.5% for a public and 40.9% for a private strategic buyer compared to a premium of 28.5% if the acquirer was a private equity firm. This month's newsletter discusses common pitfalls why strategic buyers walk away from deals even though there is great interest in the company, products, technology or its management team. But more importantly what can be done to prevent this.

Due Diligence And M&A Process

There are many reasons for a strategic buyer to do acquisitions. It could be to gain a new cutting edge technology, speed to market, increase market share or just revenue growth. Regardless of the reason, the strategic buyer will likely hire a ton of advisors to ensure that that the company up for sale ("target") is really as attractive as is presented. "Are there perhaps dead body's hiding in the closet?"

Due diligence is typically done prior to signing the binding agreements but after a letter of intent is signed or some preliminary understandings that a deal should be pursued. It spans to all relevant aspects of the past, present, predictable future of the business of a target. The process of due diligence is one whereby the entire company is subject to detail scrutiny by lawyers, accountants, consultants, industry specialists and other subject matter experts.

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Whether you decide to proceed with an interested buyer or retain the service of an M&A intermediary to find more buyers, it is important to ensure you are being represented by competent, experienced, and cost-sensitive attorneys and accountants. They are crucial in completing due diligence, reducing tax liability, helping you understand what is "market," and negotiating the letter of intent and purchase agreement.

Common Pitfalls Why Strategic Buyers Walk Away From Deals

Besides the right strategic fit, profitability and performance of the target, in order to maximize its strategic value, every seller should strive to achieve:

- ✓ Low customer concentration - to avoid any discount to the price as a result of the risk of big customer losses (rule of thumb: strive for less than 10% revenue to come from one single customer).
- ✓ Diversification of product mix - a large product mix mitigates dependency on a narrow product mix that may become obsolete.
- ✓ Stable, recurring revenues - preferably derived from contracts instead of one-time revenues.
- ✓ A strong management team - that is not solely dependent on the involvement of the founder. Have other key employees involved early in the decision making process and operations.
- ✓ Market presence - demonstrate your competitive advantage, your reputation and brand by being known in the industry, media, through your website and show continuous innovation and differentiate yourself from the competition (which first requires you to really know who your competitors and peers are).

Put your best foot forward

However, even when a target is very attractive from a business perspective, a market leader, being known for its expertise or innovation, the lack in preparation of the sale and poor financial presentation may still cause strategic buyers to walk away due to:

- ✓ Unreliable inaccurate, or untimely financial information;
- ✓ No carve-out financial information available for the segment of the business that is being sold;
- ✓ High integration costs;
- ✓ Deal issues that are not quantified or risks that are not mitigated;
- ✓ High risk of non-compliance with rules and regulation for public companies such as FCPA[3] and SEC requirements;
- ✓ Unforeseen obligations or off balance sheet exposures that have not been disclosed.

What About Vendor Assistance?

In continental Europe, some providers including BIG 4 accounting firms sell Vendor Due Diligence services ("VDD"[4]). Due to the litigious and adversarial legal system in the US, the concept of

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representing both the seller, and later, the buyer in a deal is pretty uncommon in the States. As such, VDD is not a service that is being offered here in the US, but there are significant benefits of VDD[5]. For example:

- ✓ Creating greater control over the sales process
- ✓ Reducing disruption to the ongoing business and maintaining confidentiality
- ✓ Adding credibility to facts, figures and numbers
- ✓ Identifying issues early and having time to regroup and fix potential problems.

Without performing a complete VDD or VDD report, focusing on the benefits of VDD and cherry picking the components of VDD to only those services that would solely benefit the seller, so called Vendor Assistance, could significantly help a seller becoming a more attractive candidate for acquisition.

Real Case Study:
Just before the 2012 holidays, Ms. Hsu was representing a strategic buyer in Silicon Valley looking to buy out a privately-held company in New Jersey. The initial negotiations were based on a valuation model and projections that resulted in a purchase price of $ 50 million. As part of the buy side due diligence, the target's accounting revenue recognition policy were challenged, as well as its audited historical financials. Negative price pressure resulted, and interest in the transaction nearly vanished.

Corporate buyers care very much about the future earnings and revenues to be reported after the deal closes. Even though, cash is king and valuation models are based on future cash flow statements, concerns with the historical US GAAP financials can have a tremendous impact on the deal economics and the projected revenues going forward. In the end, the deal did go through; however, the price was reduced by $6-8 million due to the issues raised at the 11th hour with little time to resolve and little knowledge to respond adequately.

How Vendor Assistance Can Help & Avoid Common Pitfalls:

Get Your Books In Order:

- ✓ Present your multiple years of historical financial information in a consistent and precise manner which reconcile to (preferably audited) financial statements.
- ✓ Make sure the numbers presented are consistent in all presentations.
- ✓ Show adjusted EBITDA to present the business on a go-forward basis, particularly in cases where high owner salaries and bonuses were used to create tax efficiencies, but unfairly compromise the real profitability of the business.
- ✓ Explain trends and deviations in a logical and positive way such that future growth is supported by historical growth.
- ✓ Explain how the company is responding to hiccups and changes in trends.

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Perform "Pre-Sale" Due Diligence or Transactional Readiness Review

- ✓ Prepare a diagnostic review of:
  - ✓ Key revenue and cost drivers
  - ✓ Key accounting policies, in particular revenue recognition
  - ✓ Key contracts, customers, vendors etc.
- ✓ Review standard sales contracts and standard terms and conditions. Assess magnitude of non-standard contract provisions.
- ✓ Review important key balance sheet and P&L items, in particular those that require significant management judgment or use of estimates.
- ✓ Assess quality of information being presented, either in data room or to be prepared during due diligence.

\- **Increase Quality Of Financial Systems, Controls Procedures & Processes**

- ✓ Prepare accounting memos or white papers for key policies, processes and procedures.
- ✓ Ensure the accuracy and consistency of management reports with financial systems/cash & bank books/key metrics, underlying subsystems, and prepare a GAAP to non-GAAP reconciliation
- ✓ Prepare Carve-Out financials using consistent and reasonable assumptions, supported by documentation, if part of business is being sold.
- ✓ Document the company's corporate governance policies and procedures, and provide documentation (minutes, reviews, tests, internal audits, etc) that those policies and procedures are being carried out on a regular basis.
- ✓ Address audit recommendations provided by the auditor currently, and by the time of sale.
- ✓ If no audit is performed, demonstrate other ways that provide credibility to the numbers (for example, beginning and ending balance reconciliation of the cash/bank account transactions, physical inventories, receivable and payables agings, etc.)
- ✓ Regardless of how big or small a company is, how sophisticated the systems /records are, proper documentation and explanation of outliers/non-standardized processes is "key" to increasing the quality of financials, even if systems, processes or procedures are very limited and mostly manual.

Other Items

- ✓ Respond to requests and address queries by taking the perspective of the buyer and understanding what you would want if you were the buyer
- ✓ Ensure appropriate language in the Sale and Purchase Agreement ("SPA") for accounting definition, completion mechanism and in particular, definition of balance sheet items, indemnities etc, (non-lawyer type language)

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- ✓ Be able to understand and explain the key terms of the deal and purchase agreement and not to only rely on bankers or lawyers to ensure you are protected but really understand what you are agreeing to. TREAT THIS AS THE DEAL OF YOUR LIFE (WHETHER IT'S THE 1st, THE 2nd or the 101st DEAL)

Summary

Selling your company is one of the most important, exciting, but disruptive events in a founder or CEO's life. Why take unnecessary risks and lose control over the sales process? There are many ways companies can prepare themselves for a sale. Regardless of the team of advisors, attorneys or accountants, the key is to ALLOW TIME TO PREPARE AND PLAN for the sale.

The Partners of CFOs2Go Partners working together with Ms Hsu take pride in helping our clients with the preparation of one of the biggest events in the company's history. If you are in the process of a sale, in talks with potential buyers and banks, or exploring an exit strategy for your company months or years from now, do no not hesitate to call Chris Chillingworth at (408) 309-1343 or Sima Hsu at (415) 706-3390. ✍

[1]Bargeron, L.L, Schlingemann F.P. , Stulz, R.M., Zutter C.J (2008), Why do private acquirers pay so little compare to public acquirers?, Journal of Financial Economics 89, 375-390,
[2]A strategic buyer is typically an operating company that acquires companies in the same industry or looks for companies that will create synergies with its existing business. A financial buyer acquires a company primarily for its return on investment. The financial buyer will hold the investment with the purpose of selling it with a significant return in the future.
[3]The **Foreign Corrupt Practices Act of 1977** (**"FCPA"**) (15 U.S.C. § 78dd-1, *et seq.*) is a United States federal law known primarily for two of its main provisions, one that addresses accounting transparency requirements under the Securities Exchange Act of 1934 and another concerning bribery of foreign officials.
[4] In a typical Vendor Due Diligence, the seller instead of the buyer will hire advisors to review the relevant documentation of the target company. These advisors will then prepare a report that will be provided to buyers to review on a non-reliance basis. As such, in the initial process the advisors have a duty of care to the sellers and no liability towards the buyers. However, once a buyer is ultimately identified and a bid is agreed upon, the duty of care and reliance shifts from the seller to the buyer.
[5] Vendor Assistance encompasses all activities to prepare the seller to maximize its value by focusing on its core competencies but leveraging the help of M&A accountants with the company's financial information and its preparation for sale.

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