CHAPTER 1

Buyers and Sellers and Their People

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While most of the companies whose names we recognize today are publicly held, the vast majority of businesses are still privately held and in most cases are owned by either an individual or a family. In the United States alone, more than 5 million small and mid-sized businesses represent the backbone of the economy.[1] While the highest-profile acquisitions, divestitures, mergers, equity investments and joint ventures (together "Strategic Transactions") take place between large public companies in well-publicized and often argumentative processes, for every such big deal hundreds of smaller Strategic Transactions take place every day. In 2005, more than 11,000 reported M&A transactions were completed, although this figure likely understates the number by failing to capture all of those smaller deals that were quietly completed between the principals without the help of outside advisors like investment bankers. When broadly defined, Strategic Transactions could be viewed to include things like the sale of a Burger King franchise or even a six-unit apartment building—both small businesses in their own rights. None of these purchases and sales of businesses are included in the M&A statistics. Even of reported numbers, more than two-thirds are usually valued at less than $100 million. For every multibillion-dollar deal, a myriad of smaller deals may not make the headlines but are getting done and changing the nature of the companies that make them.

In today's market, the population of potential sellers includes everyone from multibillion-dollar companies like America Online and Hughes Electronics to small regional family-owned businesses. While there are certainly differences between a Fortune 500 acquirer and a small family-owned business rolling up smaller competitors,

most buyers and sellers share similar goals and incentives. One particularly important lesson to learn is that in the context of strategic transactions, bigger does not necessarily mean more complex. The opposite is often true, with smaller deals involving more structuring complexity and triggering a larger number of disputes in both negotiation and the aftermath of the deal.

It is also important to remember that a bigger deal may have more zeros, but the smaller a deal is, the more likely it is that even a tiny issue will become material. In a $2-billion deal, a $50,000 issue like whether the buyer gets to keep the office desks will never blow things up, but in a $1 million deal, that same $50,000 issue can be a deal breaker. Similarly, while public company deals add the complexity of Securities and Exchange Commission (SEC) regulations, they are usually done by professional managers who may have far less of an emotional stake in the transaction than a founder of a family-owned business. Thus, as we look at these deals, remember that the players and the complexities they face can be just as interesting and challenging regardless of whether it is a large or small, or public or private, deal.

SELLERS

The choice to sell is clearly one of the most dramatic, as well as the absolute last, big decision that a company will ever make. It has dramatic and far-reaching effects on everyone associated with the company, both emotional and financial. There are a range of reasons for a company to choose to sell, driven by both internal and external factors. The decision to sell is generally a long-fought and controversial one, though it can be triggered and/or accelerated by either an internal decision to initiate a process or an unsolicited offering triggering a decision.

Decision to Sell

From a company point of view, there are a variety of reasons to sell. A company may choose to sell because it has maximized growth in its own market and does not think it can expand to new markets—

the big fish in a little pond. While trying to leverage your strength in one vertical product or technology to expand into others is certainly a viable strategy, it comes with substantial risks. For every company that successfully redefines and broadens its market space, others fail in the attempt and damage themselves in the process. The big fish in a little pond will often choose instead to cash out and sell its dominant, albeit niche, position to a larger player that is looking for a shortcut to entering that niche. Even if the big fish in a little pond does not want to sell to a much larger player, it may often choose to expand by finding a similar little fish and merging with this complementary player so that each company can leverage the other's dominance in new markets or with new products.

A company may choose to sell because it has reached a plateau and does not believe it has the resources to grow any further. An example of this would be a company that has grown in a niche market but now faces the daunting task of competing head-on with a much larger player. In the situation of the big fish in a little pond, sometimes the large outside player forces a decision by starting to encroach on the smaller company's niche organically. In this situation the small company, no matter how intent on maintaining its independence, may have no choice but to sell out while it still has a strong niche position rather than wage a painful head-to-head battle with a much larger and better-funded company intent on entering its space. No matter how independent a company may be, the day that Microsoft takes an interest in its market space is the day this company must seriously consider the sale alternative.

A company may simply be taking advantage of what it perceives as a historical peak in its valuation. Some technology companies were wise, or lucky, enough to put themselves on the block in 2000, as the technology market hit its peak. One could argue that valuations before the dot.com bubble burst will never again be reached and that selling at that time maximized value for shareholders versus any conceivable strategy for continued growth. While hindsight is 20/20, it is particularly difficult for companies to spot the market peak for psychological reasons. Part of the DNA of most successful companies is a certain amount of hubris and pride in their accomplishments. This makes it difficult for companies, particularly those having some success, to envision the possibility that they have hit a market peak. It is far more common for a company to go flying by

that important milestone fully confident that newer and greater highs await it, only to watch the slow (or sometimes rapid) slide back down.

In the case of privately owned companies, a lack of a viable replacement for the founder often drives a sale, as the founder nears retirement. One of the challenges we will discuss later in the book is the dual role of a founder as a manager and a shareholder. A rational shareholder would take into account the eventual departure of a CEO and put in place effective succession planning to ensure that someone good had been groomed to take over. But when the owner is also that CEO, it is often difficult for him or her to think beyond his or her own role as CEO, which can leave the company with no natural leadership when the founder dies or simply decides to retire. In the absence of a natural successor for a founder, there is a huge risk that the company will dramatically decline or even fail when its leader exits the picture. When this happens, the company can be forced into a rapid sale, and the lack of a complete leadership team can sometimes substantially damage the business.

Smaller companies often become resource-constrained from a lack of access to capital. To grow fast, some businesses require huge upfront expenditures to buy equipment, real estate, or raw material. At some point, the opportunities available to a smaller company, even a successful one, may outstrip its borrowing capacity, and only a sale to a larger company allows it to take advantage of these opportunities. Sometimes the big new resource demand comes with the need to expand into a new vertical, as is the case with the big fish in a little pond. In other cases, changes in the market may drive a new demand for resources. The advent of new technology, or the imposition of new regulatory requirements, can substantially increase the capital required to run a business and leave a smaller company struggling to keep up with the new realities of their old market. For example, many doctors operating individual practices might argue that the dramatic increase in the cost of malpractice insurance over the past three decades has made it impossible for them to survive and forced them to sell their practices to larger groups or join a managed-care provider.

There are a myriad of reasons to sell, but Exhibit 1.1 provides a few examples of why a company might decide it is in the shareholders' best interests to sell.

EXHIBIT 1.1 Seller Motivations

Peak of Market	Peak of Industry/Sector	New Competitors	Seeking Liquidity Event
Stock Sector Is Peaking	*Dominating Niche*	*Getting Noticed by the 800-lb. Gorilla*	*Investors Want Return*
Industry sector is peaking and decline is feared	Company is running out of space in a small niche; has picked all the low-hanging fruit	Company has grown its niche to the point where it is attracting big players	Investment has been successful and private investors want to cash out through an initial public offering (IPO) or an acquisition
Equity Market Is Peaking	*Sector Has Peaked*	*New Competitors Enter the Space*	*Family/Founder-Owned Business*
Stock valuations are perceived to be peaking and decline is feared	Traditional cash cow—strong cash flow in a declining business	New competitors emerge from adjacent geographies, product, or customer spaces	Founder is retiring and no heir apparent

Economic Model and Their Incentives/Biases

In theory, a company's decision to sell should be driven by the same goals and priorities that drive its daily operation. The decision to sell is just another business decision, albeit the largest one the company and its management team will ever make. In the United States, corporations (both public and private) are primarily driven by the goal of maximizing value for their shareholders. While some courts have embraced the notion that companies can also consider other constituents including employees, customers, and the community, it is fairly clear that maximizing shareholder value is the primary, if not sole, goal of a company. However, this is an extremely vague goal, and the specific strategy that best achieves it is always a subject of debate. Thus, while in theory a company should always choose to sell when the sale price exceeds the value shareholders will otherwise

receive from the continued operation of the company, only one, or sometimes neither, of these values can be measured accurately and certainly.

At first blush, one might argue that for a public company, the current stock price represents the most accurate value we can put on the company. If this were true, any offer to acquire a company at even a modest premium to that stock price should be an offer that shareholders should take. While the seller may be, and usually is, willing to pay a premium for control (versus the value of a small non-controlling stake), the public shareholders should not require that control premium if the current stock price is a reasonable proxy for the true value of the company. This is clearly almost never the case. The average premium for the acquisition of a public company varies over time but usually hovers between 10% and 20%. Furthermore, this does not take into account all of the acquisition offers, some at even higher premiums, that are rebuffed by shareholders.

When shareholders assess an acquisition offer, they look not only to the current trading price of the stock but also to the perceived future value. If stock markets were perfectly efficient, we would assume that the current stock price captured the risk-adjusted future value and opportunity of a company. However, the large premiums commonly paid for acquired companies suggests that either the market sometimes undervalues companies or shareholders are not purely rational in their approach to considering acquisition offers. Because management may often have a bias against being acquired, it is possible that they help drive that bias.

To the extent that we assume the market does not accurately assess the future value of a company, shareholders are left to do so on their own. We can never exactly predict the future value of a company but can only guess at it based on projections and forecasts of not only the company's performance, but also that of its peers, the industry, and the economy as a whole. Estimating the value of an operating company is an art and/or science practiced by everyone from investment bankers to investors to the companies themselves. Because investment bankers are the purported experts, I will discuss the details of these methods a bit more when I discuss the bankers, but suffice it to say that while there are a myriad of models, methods, and approaches, there are no certain answers; the most complex

model is driven at its base by assumptions that can all be debated. Deciding how much a company is worth or what its prospects are in the future as a stand-alone entity is never exact and is usually tainted by the biases and assumptions of those doing the analysis.

Acquisition offers often have variable portions that make it hard to lock down their exact value, but even when a purchase price is offered as a specific number, if it is paid in stock or subject to adjustment, its real value remains uncertain. When shareholders of an acquired company receive stock in the acquirer rather than cash, they are trading one set of business risks for another. These risks have potential upside but also potential downside. The value of a purchaser's stock can move dramatically, effectively lowering the purchase price for a company. One example is VeriSign's purchase of Illuminet. In the fall of 2001, VeriSign purchased Illuminet for a purported price of $1.26 billion.[2] This was a de-minimus premium over the market capitalization of Illuminet and was paid in VeriSign stock. On the day of the announcement, September 24, 2001, VeriSign's stock price closed at $47.01. However, over the next six months, VeriSign's stock price fell to $26.48 and continued to fall. By April 26, 2002, it stood at $9.89. The implied purchase price of Illuminet effectively fell from $1.26 billion to $265 million in a period of seven months.

Now while it is possible that if Illuminet had stayed public its own stock price would have fallen by the same amount or more,[3] it is clear that the price it received did not guarantee its shareholders $1.26 billion, but rather simply gave them a chunk of a new set of volatile securities—VeriSign stock. Similarly, a purchase price can be subject to various contingencies and adjustments related to the postacquisition performance of the company. A purchase price might have a portion set aside in escrow, to be paid only if the company hit certain sales or customer retention targets. Thus, even the purchase price of the company is often not a definite value.

The simple mathematical equation of balancing the offer price against the value of the stand-alone company is actually an educated guess at best. As we will see, a variety of biases, preferences, and points of view within a company's decision-making system will determine how the company values itself and any sale offer it receives. Many factors can trump or at least dull the focus on maxi-

mizing shareholder value. Self-interest, ego, personal wealth, and even reputation can influence the decision to accept or reject an acquisition offer. Setting aside those various biases, the exercise of valuing a company is so complex and imperfect that even if all parties are focused on maximizing shareholder value, smart people within and advising the company will often disagree on which course of action achieves that goal. This uncertainty helps explain why the decision to sell is usually a complex process with a lot of players. In most companies, the decision to sell is the result of a deep soul-searching strategy process and is usually viewed as a final unappealing conclusion. The very nature of a company and its employees is to be self-perpetuating.

While professional investors may view companies as nothing more than liquid assets and can be indifferent as to the makeup of their portfolio on a day-to-day basis, the very nature of a successful business requires a notion of esprit de corps and mission that leads employees to view the company as an end in itself rather than just a transient tool for maximizing shareholder return. Even the most reasonable company management team and board will seek a wide range of ways to maximize value that involve continuing operations and view sale as the baseline or worst-case scenario. The decision to sell is usually reached at the end of a fruitless effort to find any alternative that is more attractive and creates more shareholder value. In many cases, selling is only considered when an outsider such as a large shareholder or a bidder forces the issue.

Any decision to sell would obviously have to be approved, and is often initiated, by the board of directors. In almost any situation, it would need to be approved by the shareholders. Although some legal merger structures might potentially eliminate the need for shareholder approval, it is probably safe to assume that in any real sale of a company or substantially all of its assets, shareholder approval would be needed. For a private company, shareholder approval may be as simple as convening a meeting of the shareholders in a conference room. But in the case of a public company, receiving shareholder approval is a heavily regulated process involving extensive disclosure materials and fairly long time periods.

Closely held private companies—those whose stock is held by a small number of investors—are somewhat different. Technically, any

company incorporated in the United States has the same obligation to maximize shareholder value. However, in a closely held company with few shareholders that are generally very involved in the operation of the company, the interests of these shareholders will often drive the decision making of the company far more than the simple goals outlined in state corporate law. Effectively, a small group of shareholders can take it upon themselves to choose another priority to maximizing shareholder value. When a company has a large population of diverse shareholders, such a decision is impractical, but when the shareholder group is small and personally connected, it is not uncommon to see them consider and even prioritize factors beyond pure rate of return on their investment. We will discuss the goals and interests of large shareholders and founders in Chapter 7, but in general terms, it is important to note that when the population of shareholders is small and actively involved in the process, you are more likely to see an inclusion of nonfinancial issues in the process, or the adverse and often competitive financial interests of each shareholder group, come into play.

One exception should be noted, which is for the sale of a division, subsidiary, or portion of the assets of a company. Because this is a far less material decision and one that does not mark the end of a company's independent operations, it has far different characteristics. In many cases it will not require a shareholder vote, and if it is a sufficiently small portion of the overall business may not even require board approval. The decision-making process for the sale of a small portion of a company actually looks a lot like the decision-making process for a buyer, which will be discussed in the next section. Even if a company is selling a very large part of the business, there is a fundamentally different character to the decision.

For the company, it is a strategic decision that is meant to somehow enhance the core business, which will continue to operate; this implies that the company still believes that the continued operation of the core business is the best way to maximize value for the shareholders. At an individual level, the sale of a piece of the company has a dramatically different impact. The board and management, with the notable exception of those running the piece of the company that will be sold, will continue in their roles. While some sales trigger a dividend of cash to shareholders (or stock in the acquiring company),

more commonly the proceeds of the sale are retained in the company's coffers for use in growing the remaining core business. In that sense, the sale of a division can actually provide the remaining management team with capital to make the company more successful; this is particularly true when the division in question is perceived to be underperforming or not a good fit with the rest of the business.

Management of or Interaction with the Seller

A company's decision to sell is like a break in a dam. It triggers a cascade of other events and effects upon the company and its people. The decision is usually hard-fought, but once made it is difficult to reverse. Having made the decision to sell, the company becomes embroiled in the formalized process, and the inertia of that process will make it fairly unlikely that the company turns away from a sale unless the price eventually offered is exceedingly low. Once a company commits to a sale, it changes the very nature of a company. Management and employees are focused on the sale rather than on operations. The board of directors in particular focuses intensely on this huge final decision with which it will be faced. Competitors and customers quickly become aware of the process, the former circling like sharks and the latter quickly questioning the future of their relationship with the company. Information about the company and its operations are shared with potential buyers including, in many cases, competitors and potential competitors. Once a decision to sell has been made, there is increasing pressure to complete the process quickly to minimize damage to and uncertainty about the company.

It is important to recognize this effect when dealing with a potential selling company. Once you approach a company with a purchase offer, you fundamentally change the nature of the company and the way it behaves. As in theoretical physics—where the very act of observing some subatomic phenomenon changes them—the very act of making a bona fide offer changes the company you are approaching. Similarly, once you make a formal offer, your relationship with the company changes. Preoffer, a company is much more free to have discussions and, in general, to act. In the status quo a company is free to conduct its business in all but the most dramatic situations, in

which it needs to defer to its board of directors or shareholders. However, once a sales process begins, the actions of a company are severely limited and will be heavily scrutinized by shareholders and regulators. Preoffer, a company is likely to be more open to informal discussions and its staff more willing to share information. Postoffer, a company and its staff will clam up as a formal process is organized and then executed under the ever-watchful eye of lawyers, investment bankers, regulators, board members, and large shareholders.

Ironically, a company will easily share a wealth of information with a potential partner or client that it will be highly hesitant to share with the same company once it has identified an interest in acquisition. The lesson here is simple: Before launching an offer, get as much information as you can from the target company, because postoffer they are likely to be far more rigid and formal. The same is probably true of other potential bidders. Once a process has begun, while a bidder's actions may not be subject to the same level of corporate governance scrutiny (as will be discussedlater) as a seller, they will be much more wary of potential competitors for the target. Preoffer you are another industry player, but postoffer you are a clear competitor for a particular prize.

BUYERS

Being a buyer is dramatically different from being a seller. While the decision to sell (unless it is a division or small portion of the assets) is a total and final decision, the decision to buy is one that perpetuates and grows the business. If selling is cashing in your chips, buying is doubling down on your bet. But unless the purchase is of truly dramatic size, it is usually far less material to the buyer than to the seller. A purchase may represent only a small percentage of the overall size of a buyer's business, while a sale is by definition 100% of the seller's investment (again, unless it is the sale of a division).

The decision to be a buyer used to be a fairly dramatic choice but now is a standard business tool utilized by many, if not most, companies. The use of Strategic Transactions has gone through several phases over the last few decades. Before the 1970s, Strategic Transactions were rarely used and hostile acquisitions were almost unheard

of. But starting in the early 1970s, the art of M&A began to develop, and the hostile transaction became a viable and socially acceptable business tool. Since then both the dollar volume and number of Strategic Transactions has grown dramatically with notable peaks. In the latter half of the 1980s, there was an average of about 2,600 deals with an average size of $75 million (see Exhibit 1.2). During the same period in the 1990s, this had grown to an average of about 7,000 deals and $119 million.[4]

The collapse of the technology bubble drove a very short-term lull in transaction volume and size, but after only three years the trend had returned to almost bubble-level highs, and that trend continues into 2006. Another demonstration that Strategic Transactions have become a standard business tool is the development of a rich literature (including this book) and meeting and conference circuit devoted to various aspects of strategic transactions. The popularity of both *The Deal,* a publication aimed primarily at the investment banking and advisory community, as well as its sister publication *Corporate Dealmaker,* aimed at the rapidly growing community of corporate development officers within corporations, demonstrates

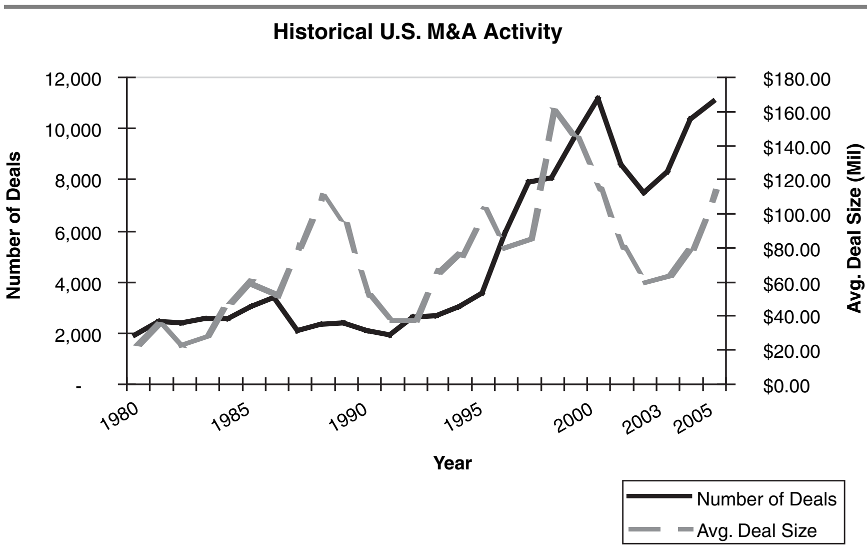

EXHIBIT 1.2 Historical Size and Volume of M&A Transactions
Source: Factset/Mergerstat (2006), www.mergerstat.com

the broadening interest in strategic transactions. The increasingly wide range of advertisers in these two publications demonstrates the growing industry that surrounds the greater use of these deals as a growth tool.

It is clear that strategic transactions have begun to have a material impact on the economic landscape of the United States, and in recent years Europe and Asia as well. What is less clear from the raw data is the general shift of Strategic Transactions from a specialty tool of a few large companies to a standard weapon in almost any company's growth arsenal. As recently as the early 1990s, allmost all companies—even many of the Fortune 500—viewed strategic transactions as arcane and complicated deals with which they were uncomfortable, and they depended on more traditional business tools such as marketing, sales, and partnerships to drive high-growth goals. But today, Strategic Transactions are an accepted and common business tool employed by thousands of companies.

While a few companies still have a particular reputation as M&A shops, like Tyco (until its recent accounting "challenges") and Oracle, thousands of other companies have done one or more acquisitions or divestitures, and hundreds have used their own in-house teams to support an ongoing Strategic Transactions effort. This phenomenon will be revisited when we discuss the role of in-house corporate development specialists and in-house Strategic Transaction lawyers, in contrast to their outside legal and investment banking counterparts, in Chapters 4 and 9.

The result of this shift is that the decision to become a buyer is not nearly as dramatic as it once was. At one time, the decision to become a buyer would have been treated as a dramatic strategic shift requiring long and sustained discussion at the executive and board level and would have attracted the attention and comment of large shareholders. While the board and shareholders will certainly continue to take an interest in any transaction large enough to have a material impact on the company, today the fact that the deal is a Strategic Transaction rather than a capital investment, marketing plan, or regional expansion will not raise eyebrows. Strategic Transactions are just another tool, and the question today is not the "how" but the "how much." Any large or even midsized company likely makes Strategic Transactions a standard plank of their strategic

planning process. Rather than asking each year whether they should partner or acquire, most companies now presume the use of such tools and focus on what they should acquire and with whom they should focus.

Nonetheless, it is important to point out that while Strategic Transactions have become more commonplace, they have not necessarily become less risky. In addition to the legions of professional advisors, there are now hundreds of in-house deal specialists. Over the last three decades, all of these people have developed a massive collective expertise in doing deals. Even so, Strategic Transactions remain a highly risky way of trying to grow a business or create shareholder value. Various studies suggest that anywhere from one-third to two-thirds of the Strategic Transactions done actually destroy value.[5] Therefore, even for a company with extensive experience and seasoned advisors, the decision to do a Strategic Transaction is not taken lightly, but companies have gotten somewhat better at managing the process of the decision and the deal itself.

Companies that have never done a Strategic Transaction may have an initial discomfort with the notion. This is no different than the discomfort and uncertainty a company would have with any new large investment. For example, for a company that does not do much marketing, the decision to buy a Super Bowl ad would probably raise concerns and require substantial internal debate and discussion. However, for a company with some level of comfort with Strategic Transactions, the decision-making process for a single acquisition will be no different than for any other large corporate transaction and will probably receive a level of scrutiny commensurate with its size and/or profile. In other words, a large, controversial, or politically charged acquisition will receive the same scrutiny as a large, controversial, or politically charged marketing campaign.

As with any other corporate decision, there is usually (though not always) a sponsoring business unit, which is promoting the idea. This unit will present the idea to an appropriate level of executive management, and the decision will be driven upward toward the CEO or board of directors, as high as it needs to go given its relative importance. For a $10 billion company, a $5 million acquisition may be done with almost no discussion with anyone outside of the relevant division. By contrast, the same company doing a $5 billion acquisi-

tion would almost certainly seek board approval and, in some cases, even shareholder approval. But, the level of decision making will generally be based on the size of the individual deal being proposed.

Having said that, given the internal infrastructure that a company needs to sustain a formal acquisition program, the decision to use Strategic Transactions as a regular and repeated tool will usually merit a formal decision in and of itself. Each time a company does a Strategic Transaction it will need to field a full team of professionals and go through a series of decision-making steps. If the company envisions doing this regularly, it will likely choose to set up formal teams and mechanisms rather than running a repeatedly ad hoc process. At that point, the company is making a decision not simply to do a single deal, but to become a regular buyer, and that decision does have strategic implications that will have to be discussed. Once a company makes the general decision to use strategic transactions as a regular business tool, it will likely give some senior executive general authority. In some cases this is the person's sole job and in others it is an add-on position, such as CFO and SVP of corporate development. Depending on how much of the costs the company wants to pull in-house, it may hire a specific-purpose team and add lawyers to their legal team with specific skills. While in most companies the corporate development team is a small team of three to four "quarterbacks" who pull together resources from other parts of the company to do deals, some companies have built massive deal teams to focus exclusively on Strategic Transactions. In its heyday, the Business Affairs team at AOL had more than 100 staff members—highly paid professionals—dedicated to Strategic Transactions.

Once a company has made the decision to become a buyer, either for a specific deal or for a series of deals as a general tool to grow the business, it will put in place a formal review and decision-making process for the deal(s). One of the differences between Strategic Transactions and other large capital expenditures is that they tend to involve a wider and more complex range of issues and touch more parts of the company. For example, a marketing expenditure, like a major marketing campaign, may only require active input from the marketing and finance departments and the relevant division head. By contrast, any Strategic Transaction will require, at a minimum, active involvement from the relevant business unit leader and staff

with leadership roles in finance, legal, technology, human resources, and public relations. As a result, the decision-making process for a Strategic Transaction is likely to be fairly complex because there are more relevant parties and more inputs to the decision—and in most cases those inputs will affect each other. For instance, the HR department's assessment of the challenge of retaining key employees can drive changes to the finance view of the financial model as well as the legal department's view of the noncompete agreements needed.

There are several reasons why a company chooses to become a buyer. Beyond the decision to acquire a specific target, a company generally chooses to become a regular acquirer when it is facing barriers to growth and/or increase of shareholder value. While growth is usually the goal, sometimes a company will be seeking to increase margins or to solidify its market position.

In every case, an acquisition is an alternative to an internal "build" strategy. Every Strategic Transaction is, or should be, prefaced by a "build versus buy" analysis. At its core, an acquisition is an alternative—usually faster, more efficient, or more cost effective—method of building something that the company wants or needs to fuel overall growth and/or success. As we will discuss shortly, there are many different reasons for doing a deal, but, in all cases, it is being done as an alternative to doing it yourself. When a company makes a strategic decision to become a regular buyer, it has decided that in many, or most, cases in the future, the buy option is going to look more attractive than building.

There are a variety of reasons for a company to make a specific acquisition. A company can acquire a direct competitor to reach a new set of customers or for a brand it has developed. A company can acquire another company to enter a new geographic region. A company can acquire a target that has developed a product or a technology that the acquirer wants to add to its portfolio. In some cases, a target may even be acquired for the quality of its management or staff alone.

Biotechnology and new international markets are two good examples. Development of new technologies takes time, and in some cases no amount of resources will substantially shorten that development time. A company with a powerful sales channel may be willing to pay to acquire companies that have invested that time, because the

delay in getting a product to market costs the acquirer more than the premium it will pay to buy versus build. This is particularly true in biotechnology. Given the long development cycle for new drugs, big pharmaceutical companies will often acquire small drug developers once they have gone far enough down the development path with a promising drug. Merck or Pfizer could develop the drug on its own, but the lost profits from having to wait an additional five or ten years to start selling the drug far outweigh the acquisition price. Similarly, many companies will use an acquisition to enter new geographic markets, notably outside their home country. Because the process of hiring staff, building facilities, and launching operations is far more complicated in a new legal, language, and cultural environment, it is often far more efficient to buy a prebuilt infrastructure and staff that works in the local environment.

There are a myriad of reasons to acquire, but Exhibit 1.3 provides some key categories and selected examples of why a company might decide it is in the shareholders' best interests to buy versus build.

EXHIBIT 1.3 Buyer Motivation Examples

Geographical Expansion	Brand	New Products/ Technology	Customer Base	Pure Economies of Scale
Build versus Buy Local Presence	*Repositioning Through New Brand*	*Emerging Technology*	*Bad Product, Good Customers*	*Merger of Twins*
Cost of setting up new operations abroad exceeds cost of purchasing local competitor	Much cheaper to reposition company by acquiring existing brand than by trying to remake existing brand	Smaller entrepreneurial companies develop a new technology to the point of effectiveness and a company then acquires them to "leapfrog" the process	A competitor is not good at providing service or innovating but has a great customer base that is easiest to reach by buying the competitor	Two companies with very similar operations can benefit purely by merging and eliminating redundancies

Decision to Buy Example

Different buyers have different models for who runs a deal and where the decision-making power lies. We can begin by identifying the key players within the buyer. Different companies have different corporate structures, and some do not have all of these roles filled, or have consolidated them into fewer individuals, but broadly speaking these are the key players in the buying decision. At the executive level, the CEO, COO, and CFO may all be involved. There may be a head of corporate development reporting to the CFO or CEO, or in some cases reporting to the General Manager of the relevant division. There is the General Manager of the division, who may also have a divisional CFO or head of strategy. Finally, there is the in-house attorney, who in almost all cases will report to the General Counsel. While other members of management are involved in the transaction, they generally have a more peripheral role, providing advice and assistance in execution and due diligence. But it is important to note that these other support functions are also spread across different parts of the organization. Exhibit 1.4 is an example of what a corporate structure could look like.

But it is important to note that these other support functions are also spread across different parts of the organization. One example of a corporate structure could look like this:

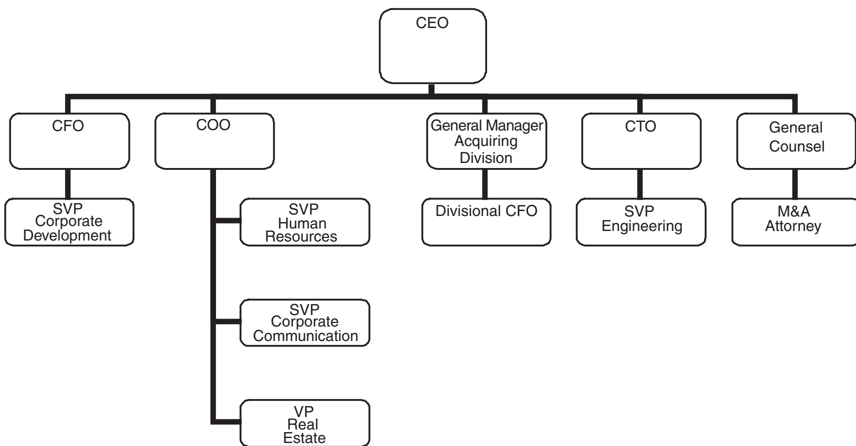

EXHIBIT 1.4 Sample Corporate Org Chart

Throughout this book we discuss the major players in the buyer decision-making process individually and focus on each of their particular roles, biases, and goals. However, it is important to note the interplay among them. Every company has both formal and informal power structures, and these can often determine how the company makes acquisition decisions. In some companies, the general managers of the business units have tremendous authority and will drive acquisition decisions in conformance with their divisions' growth strategy, with the corporate staff executives serving primarily to support those deals. In other companies, corporate executive staff may push deals down on divisions, and some deals are actually done at the corporate level and do not involve adding to an existing division but rather adding a new division or line of business. Different corporate executives wield different amounts of power in each company. In some companies the General Counsel is a senior decision maker and often has a "consigliore" position to the CEO. In other companies this person is a purely legal support mechanism who has little impact on business decisions. In some companies HR is a powerful driving factor and company culture is paramount and considered strongly in an acquisition. In other organizations, HR is simply a box that must be checked when doing a deal but never a deciding factor.

Understanding the power structure within a buyer is absolutely key. Because different players in an organization have different priorities, the way you conduct a negotiation is dramatically impacted by who the decision makers are. Even when everyone has the best interests of the company at heart and is seeking to maximize shareholder value—not always the case—different people have different perceptions of what the best interests are and therefore have different approaches. Lawyers may focus on risk and downside, line managers on product and customers, and executive managers on finance, synergies, and market perception. Because most deals are an exercise in exchanging what is of greatest value to you for what is of greatest value to me, understanding the power structure in a company may give you the key to creating an optimal deal. For example, if a buyer's decision is going to be driven by the General Manager who is focused on growing his division, then you may be able to extract a higher purchase price (which technically may come out of the corporate balance sheet rather than from his division) if you are willing to tie it to

a performance-based earn-out. By contrast, an authoritative General Counsel may nix this approach because earn-out provisions are incredibly complicated and notoriously difficult to enforce.

Just as it is important to understand the decision-making process to maximize the value of a deal with a buyer, it is also important to understand that process and the behavior of the buyer for the potential it affords you to protect yourself. Although sellers have the final power to accept or reject an offer, buyers are able to have a significant and sometimes irreversible impact on a seller, simply by making an offer, and sometimes by making it public. So, it is important to manage buyers carefully.

During the course of a deal, power will often shift repeatedly back and forth between buyer and seller. Here is an example: At the beginning of the process, a seller can be seen to have power because it determines the timing of launching a sale process, to match the market conditions and its corporate and shareholder goals. But, if a buyer announces, or even privately makes, an unsolicited offer, some of that power shifts because the buyer is now potentially forcing the seller's timing. However, if the seller is then able to rebuff the offer, it gains some power because the buyer has now given away information, including a basement price it is willing to pay. The ability to tell the seller's shareholders about the offer can give the buyer some power because once the seller is perceived to be in play, its board of directors is burdened with a lot of formal legal obligations. The seller may recapture some power by launching a formal sales process, which brings other buyers into the game, but the initial buyer will regain leverage if it is determined to be the high bidder and enters negotiations.

This is just one example of the seesaw effect as power and leverage go back and forth in a deal. Notably, the buyer can exercise a lot of power over, and have a significant impact on the action of, the seller even if it is not the winner or if the seller has not yet chosen to sell. Although deals rarely become formally hostile and are fought through a full proxy battle,[6] a more subtle form of a hostile approach by the buyer could include approaching members of the board, large shareholders, or even the press to bring outside pressure on management to come to the table. Thus, in many ways a buyer is more dangerous before it has even formally become a potential buyer than after it makes an offer.

Economic Model and Their Incentives/Biases

Just as there are two layers to a company's decision to buy, there are two layers to the economic model and incentives of the company. This section discusses these issues for the company as a single entity, but subsequent sections will revisit these issues for individual players within a company, and as you will see, the incentives often diverge between a company and its people.

To understand the economic model a company is using to evaluate deals and which drives it to do deals, you have to understand the expectations being placed on the company by the market and its shareholders. A company's economic model is driven by a single goal of maximizing shareholder value. The value of shares, and of the company as a whole, is generally driven by a combination of two factors: profitability and growth. Thus the economic model for an acquisition must offer the opportunity for some combination of these two. In theory, a company should be willing to wait a long time for growth or profitability to materialize, if it is large enough. If an acquisition holds the promise of massive growth or profit in five years, this should be a good deal for the company. However, this assumes that investors in the company take a long-term view. When investors are focused on the short term, and flee a stock that does not deliver results in the short term (thus dropping the price of the stock), they create an economic incentive for companies to focus on the short term. So even a rational company, driven by the goal of keeping its stock price up, may choose to focus on short-term economic impact. Similarly, if the market has expectations that are biased toward one factor like growth over others such as profitability or the sustainability of financial performance, a company may have an incentive to focus on similar economic metrics in its acquisitions. In a sense, a company may act schizophrenic because the goal of maximizing shareholder value is driven by the stock price, which is in turn driven by market behavior. Market behavior is not a singular event but the amalgamation of many investors who have different focuses and different time frames.

This is one way in which private companies may be far more rational in making choices on Strategic Transactions. With a single or small number of actively engaged shareholders, a private company

may be given more leeway to consider strategies that maximize value in the long term, even if those strategies require investments or other actions that create a drag on corporate performance in the short term. However, even a private company is subject to the vagaries of the market indirectly, because the implied value of the company is tied to the market value of similar companies. Not only do those values often drive a short-term focus, but they can also change depending on other market forces. For example, during a downturn in the market, investors will become focused on profitability and stability rather than growth and attach a greater premium to those financial characteristics. The valuation of a company that has been sacrificing profitability by investing in capital expenditures and marketing to drive growth will suffer in that environment.

By contrast, in a robust market shareholders may attach greater value to growth and actually punish a highly profitable but slow-growing company. This certainly was often the case during the technology boom of the late 1990s. If a private company shareholder plans to sell its stake in the short or medium term, it knows that the eventual valuation it will receive in an initial public offering (IPO), or even in a private sale, will be tied to those same metrics that drive public company valuations. The only companies safe from this impact are private companies where the shareholders plan to continue to own the companies indefinitely and thus find value purely in the profit generated and growth rate thereof. For any other company—which is the vast majority—maximizing shareholder value is a deceivingly simple economic model under which lies a shifting set of economic goals. On any given day, goals can drive companies to seek growth, profitability, protection of capital, or even just a reduction in volatility—all in an effort to maximize shareholder value in the form of the stock price, based on the current and sometimes fleeting preferences of the market.

Management of or Interaction with the Buyer

Any sale process begins with the initial decision to put a company on the block. Sometimes this decision is made by the seller and sometimes it is thrust upon the company. We've already discussed how a

seller may decide to sell and how a buyer might force that decision on the seller. A large shareholder might also force the issue by raising the question of why the company is not being sold or trying to stimulate an unsolicited bid. Once the decision is made or forced, the seller has to decide how to manage the buyer(s), and that means deciding on a process. A process can be as simple as deciding who leads the negotiation or as complex as a tiered auction allowing bids on different portions of the business.

There are several models for managing buyers and the sales process. There is a broad literature available on this topic, which discusses various methods and processes and reviews the pros and cons.[7] Let me briefly review some of the most common models, which will help color our discussion of each of the players and the roles they play. The simplest process is a direct negotiation with a single buyer. In this situation the seller directly engages the buyer and, as the discussions progress, gives the buyer access to due diligence materials, and the parties begin to frame the terms of the deal. A more complex process involves simultaneous negotiations with multiple buyers. A variation on this method is a formal auction, where buyers are contacted and put through a formal bidding procedure. In some cases it will be a two-step bidding process, where initial bids are received and the population of buyers is culled down to a smaller group that proceed to a second round, where they receive more complete due diligence information before putting in a final bid.

For example, this is the process Vivendi used in the sale of its entertainment properties, where Marvin Davis was eliminated in the first round and Vivendi then further trimmed the field in a second round. In some cases, a seller will further widen its range of options by running a sale process in tandem with preparation for an IPO. The complexity of running these two tracks is sometimes offset by the opportunity to keep both options on the table if it is unclear which will yield the higher valuation, at the end of the day, for shareholders. Exhibit 1.5 is an example of a sales process that is orchestrated in tandem with an IPO process—often an alternative strategy to a sale that a seller may pursue simultaneously.

Another variation on the sales process is bankruptcy. This is a situation where management effectively transfers control of the process to the bankruptcy court and by proxy to a trustee. Each year tens of

Here is an example of a sales process that is orchestrated in tandem with an IPO process—often an alternative strategy to a sale that a seller may pursue simultaneously:

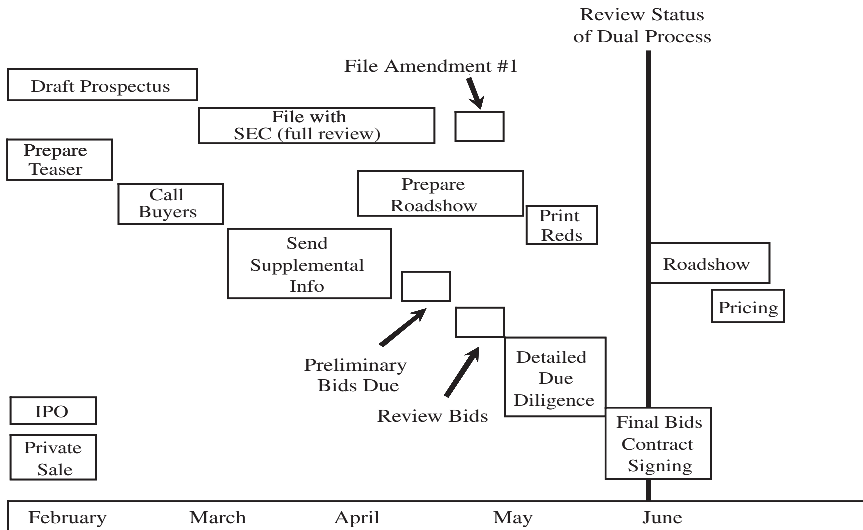

EXHIBIT 1.5 Sample Sale Process Map

thousands of companies file for bankruptcy in the United States, and while some are liquidated, others are reorganized and maintained as operating businesses under Chapter 11 of the bankruptcy code.[8] There are many reasons why a company may choose to go into bankruptcy, but once there, the board and management have the dubious comfort of ceding control of the process. Bankruptcy sales processes for large companies are not that common, although when they occur they can generate dramatic change in these companies and impact entire industries. The bankruptcies of both United Airlines and Kmart Corporation are good recent examples of large U.S. corporations whose bankruptcies and subsequent reorganizations have had impacts on not only their own employees and shareholders but on their whole sector.

While some bankruptcy sales simply break down the assets of a defunct company, often the court entertains offers for the sale of the business as an operating entity. The bankruptcy court has a wider berth to consider factors like benefits to the community and to em-

ployees. The sale of a company as a whole rather than breaking it down into its base assets may sometimes yield more value for the creditors (the primary financial beneficiaries of a bankruptcy sale) but also do less damage to the community and employees by keeping the business going—at least in some form. This bankruptcy process tends to be even more formal and drawn out than a management-run auction and is open to public scrutiny through published court documents.

Confidentiality is often an important issue, particularly in more complex sales processes. Sometimes sellers will keep the process confidential in an effort to keep buyers from identifying each other. Doing so increases uncertainty among buyers and the fear that competitors may be bidding as well. It also attempts to block buyers from colluding. Keeping a sale process confidential may also manage or delay the damange that can be done to a company that is put on the block. Companies going through a sales process have a higher risk of losing customers and employees, both of whom may flee in the face of the uncertainty about the company's future. A highly public sale process can, in and of itself, substantially damage a company.

On other occasions the seller will choose to publicize a bidding process. The seller may be forced to do this to placate shareholders, who want to ensure the process is maximizing value for them. This is particularly true when the sale process was precipitated by an activist shareholder, who will want to observe the process closely, and in some cases even participate in its management. The seller may also make the process public to ensure that all possible buyers are brought into the process. Buyers will usually press for a confidential process at least early on, because if negotiations are public, the buyer's involvement in an auction can sometimes bring a negative reaction from its own shareholders, regulators, or competitors.

A seller often does not have any choice about a process becoming public. While in theory a sales process is run by an investment banker who works for the seller, and each potential bidder signs a nondisclosure agreement, in practice, the leakage of information about the sale of a company is almost inevitable. Wall Street is a small community, and bankers will often discuss deals with each other and with other clients. The same can be said for the professional investment community of private equity and venture capital firms and, in fact, for many tightly knit industries. A seller will often choose to make a sale public to ensure that it can spin the story to its benefit rather than having

the information leak out, potentially with negative implications about the health of the business.

At the height of the dot.com boom, I was approached by the CEO of a small company that was conducting an auction process. My company was one of the largest and most obvious bidders for his business, and he wanted us to participate in the auction. My team had the time to do an initial review, and so I was glad to say yes and assign someone to look at the company. But soon one of my staff came to me with a problem: The company's lawyer had given him a nondisclosure agreement (NDA) to sign, and he carefully reviewed it and noted that it provided one-way confidentiality. We couldn't talk about the auction, but the seller was not technically barred from announcing that we were a bidder. This was an unusual term, and the seller's young lawyer was being difficult and looking to score points. He had no idea how big a can of worms he had opened.

After a long and fruitless argument with him about the unfairness of this term, we took a more direct approach. We called the seller's CEO and gave him a clear ultimatum: If the NDA didn't protect our anonymity, we would refuse to participate. He was quick to correct his lawyer, but this wasn't an idle threat. As a then $12 billion company bidding on a $50 million to $100 million company, the potential impact of a negatively perceived announcement far outweighed the value of the whole deal. If the press learned we were a bidder and without the opportunity to make a formal announcement and "spin" the deal, shareholders might view it negatively. If those negative views caused even a tiny 0.50% drop in our stock price, that would translate into a loss of $60 million of market capitalization—almost the value of the whole deal!

For a company with a volatile stock price and where the market is particularly sensitive to news about Strategic Transactions, confidentiality can be a powerful issue for buyers. I should note here that an NDA is no guarantee of confidentiality. It does give one party the ability to sue the other for disclosing information, but there is a big difference between identifying that a leak has occurred and proving in a court of law that someone is the source of that leak. As we will discuss in this book, Strategic Transactions involve a wide range of players with diverse incentives. A general rule of thumb is that the longer a Strategic Transaction is being discussed, and the more

parties involved, the more likely it is to leak into the press or to other parties like competitors, clients, and investors. Thus, when a company considers engaging in a Strategic Transaction (on either side), it should obtain NDA protection as a method of putting pressure on the counterparty to maintain confidentiality, but it should assume there is always a significant risk of a leak and plan for that event.

We see that when dealing with both buyers and sellers it is important to understand their economic goals and perhaps more important their internal processes; and the larger a company is, the more tied it will be to those processes. Even as Strategic Transactions become a more common and understood business tool, different companies maintain substantially different approaches to how they do these deals and who has what role in the process. Thus far we have considered buyers and sellers as the two players in a deal; now we will broaden the scope substantially.

There is always a tendency to think of corporations (both buyers and sellers) as unified entities. We anthropomorphize them and think of them as individuals, almost as big, powerful people. One might say "General Motors did this" or "Disney won't like that" and personalize companies as if they think and act with a single mind and purpose. When describing or reporting the actions of corporations, there is a need to simplify the complexity of the myriad of factors that drive these entities and treat them as a single unit, like a hive or a flock of birds. The press certainly adds to this tendency, and it is understandable. It is far easier to report on a company as a single actor than to tell a complex story of all the shifting and variable players under its skin, so the press generally treats companies as single-minded individuals. Of course, outside the world of George Orwell and various science fiction movies, they are not. They are a collection of various types of individuals with differing and often conflicting agendas and interests.

This is a particularly crucial insight in Strategic Transactions. Because strategic transactions tend to bring about dramatic change and often trigger a fundamental shift in direction, strategy, and plans, the differences in these agendas and interests often surface. Thus it is important to look not only at the buyer and seller as players in the process, but also to look at the particular individual players that drive the behavior of these companies. While a small company may

have dozens rather than hundreds of thousands of employees, in an acquisition or sale, both small and large companies tend to field a similar group of people who participate or have a voice in the deal.

The rest of this book is concerned with discussing the individual players that work together (both inside and outside) to make these buyers and sellers act. In a way you can think of these companies as those animatronic movie monsters, which are in reality operated by a dozen or more different people, each with responsibility for a different part or action (e.g., the arms, the legs, the fire and smoke from the mouth). We are now going to look at each of the individuals or groups that together operate "the monster," because understanding their individual roles, biases, and motivations is key to understanding the behavior of the companies in which, and for which, they work.

NOTES

1. In 2002, there were 3,466,000 businesses with 0 to 4 employees, 1,1011,000 businesses with 5 to 9 employees, 614,000 businesses with 10 to 19 employees, and 508,000 with 20 to 99 employees. 125th Statistical Abstract of the United States 2006, p. 515, (data provided by the U.S. Census Bureau).
2. *M&A Journal,* Vol. 37 No. 2, p. 66.
3. However, during the same period, the Invesco Telecommunications Fund (ticker: ITHCX) actually appreciated by a small amount.
4. "The 1990 Profile," M&A database, M&A Journal, Vol. 25, No. 6, p. 36 for 1980s data; "The 1999 Profile," M&A database, *M&A Journal,* Vol. 35, No. 2, pp. 25,41 for 1990s.
5. Much has been written about the failure of strategic transactions. One recent article sites studies that 64% of the M&A deals done in the United States between 1985 and 2000 destroyed value ("The Return of the Deal," *The Economist,* July 10, 2003). Another article argues that when properly measured, the number is closer to 30% (Robert Bruner, "Does M&A Pay? A Survey of Evidence for the Decision-Maker," *Journal of Applied Finance,* Spring/Summer 2002, Vol 12., Issue 1, p. 48). Either

reading of the data tells us that strategic transactions are no slam dunk, and there is a significant risk that a deal will destroy value.

6. Note that since a hostile takeover is really the exercise of going over the heads of the board of directors when they reject your offer, and appealing directly to the shareholders to sell their stakes, this is almost exclusively a tactic used to acquire publicly held companies with a diverse shareholder base. For privately held companies or public companies with one or two shareholders holding a majority of the stock, the board of directors is almost always a direct reflection of the views of those controlling shareholders, so a rejection by the board is tantamount to a rejection by the shareholders, which is unappealable.
7. Excellent sources include: Peter Hunt, Structuring Mergers & Acquisitions: A Guide to Creating Shareholder Value (Aspen, 2003); Lou Kling and Eileen Nugent-Simon, Negotiated Acquisitions of Companies, Subsidiaries and Divisions (Law Journal Seminars Press, 1992); M.D. Ginsberg, Mergers, Acquisitions, and Buyouts (Aspen, 1997).
8. Since 2000, there have been an average of 37,096 bankruptcy filings each year, with 39,201 filings occurring in 2005. American Bankruptcy Institution, Bankruptcy Filing Statistics: http://www.abiworld.org/ContentManagement/ContentDisplay.cfm?ContentID=18753. During the 1990s, bankruptcies actually peaked at more than 70,000 in 1991. AmegaGroup. www.amegagroup.com/enewsletter/quarterlybankruptcyfilings.htm.