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Chapter 1

Explaining Mergers and Acquisitions

Mergers and acquisitions is a complicated field, so this chapter provides an overview: an introduction to the basic terms and phrases, a discussion of decorum and the basic M&A process, a look at the players and the category of deals, and my handy-dandy guide to helping you, the business owner, determine what kind of business you have.

Defining the Term

Mergers and acquisitions (or *M&A*, for short — the M&A world is rife with acronyms and initialisms) is a bit of a catchall phrase. For all intents and purposes, *M&A* simply means the buying and selling of companies. When you think about it, mergers and acquisitions aren't different; they're simply variations on the same theme.

In the simplest sense, a *merger* is a combination of two or more entities where each merging entity has an equal stake in the new enterprise and each merging entity has a clearly defined role in the new entity. This ideal is the vaunted *merger* *of equals.* The automobile giant Daimler's 1998 combination with Chrysler was a merger of equals. In a more practical sense, so-called mergers of equals are rare; one side usually ends up controlling the enterprise. For example, the years following the Daimler-Chrysler merger showed that Daimler executives planned all along to control the combined entity.

REMEMBER

Although actual mergers do occur, most of the activity in the M&A world centers on one company buying another company — the acquisitions category, in other words. I like to think that using the word *merger* keeps the uninitiated on their toes; plus, talking about combining two companies as equal partners rather than about committing a hostile takeover sounds much more egalitarian.

If you want the insider's view, mergers are far less common than acquisitions. An *acquisition* takes place when one company buys another company, a division of another company, or a product line or certain assets from another company. Although some companies grow *organically* (from within, by creating and selling products or services), an acquisition allows a company to bypass the growth stage by simply buying existing sales and profits. Starting up a new product line may be less expensive than buying an existing one, but the market may take a while to adapt to the new product, if it ever does. For this reason, buying other companies rather than relying on organic growth may make sense for a particular company.

The fact that one can transfer a company's ownership through a sale often comes as a bit of surprise to many people — including many business owners, believe it or not. Business owners, especially owners of middle market and lower middle market companies (with revenues between $250 million and $1 billion [middle market] and between $20 million and $250 million [lower middle market]), have spent their careers building a company, so the process of selling a business is often a task that is new and foreign to them.

In addition to being an activity, M&A is an industry. As this book illustrates, the steps to doing a deal, the names of documents and processes, the conventions, and the sundry tips and insights I provide are all based on *de facto* industry standards that have developed over time, and my humble hope is that this book helps introduce you to those standards and conventions.

Seeing How M&A's Occur

M&A, as described a little earlier in this chapter, is the buying and selling of companies. But companies don't sell themselves. At the heart of M&A (and this book) is the M&A process. So, how does all this exciting M&A info manifest itself in the real world? What happens when rubber meets road, when things get real, when the moment of truth arrives — or when your humble author ceases the use of clichés? Wonderful question, and I thought you'd never ask! Let's take a look:

- **M&A is not nebulous.** One common misconception that I regularly hear concerns the nature of M&A work. Many people seem to think that a) investment bankers have an inventory of product (companies for sale) and b) such bankers sit by the phone, waiting and hoping to be contacted by buyers interested in acquiring a company. In this flawed view, a huge universe of sellers is orbited by buyers; scores of investment bankers float in the ether, hoping to be contacted by a buyer who might deign a client's company as worthy of acquisition.

  Nothing could be further from the truth.
- **M&A is a process.** Whether a company is being bought or sold, in almost every M&A situation a process is in play. Even if a company is sold on an *ad hoc,* proprietary basis, some semblance of the M&A steps described in this book are utilized. I strongly encourage you to check out Chapter 3, where I discuss these steps in more detail.

In this process, a business owner or an executive hires an advisor (often an investment banking firm) to proactively execute a particular mandate: say, sell a company, buy a company, or raise capital. That advisor is the one who creates the materials, contacts counterparties, solicits offers, sets up meetings, negotiates deals, and helps close transactions. These activities occur as the result of planning, not happenstance.

Introducing Important Terms and Phrases

Like any topic, M&A has a language that you need to understand. Although I introduce many more terms and phrases throughout this book, the following words are part of the basic building blocks of M&A.

REMEMBER

The *lingua franca* of M&A is an amalgam of accounting and banking terms sprinkled with initialisms, acronyms, and words and phrases adjusted and twisted to suit certain needs at certain times. Pay close attention to the terms I define throughout this book. Although some are tricky, I use them all for a reason.

Buyer

You can't sell something unless you have a buyer for it. Buyers are typically companies or entities, but individuals can also be buyers; therefore, the use of *buyer* can apply to a company or a person. Also, *buyer* might apply to potential buyers as well as actual buyers.

REMEMBER

In documents, contracts, and agreements, you might see *Buyer* as a defined term — so it's capitalized with a capital *B.* When you read those documents, *Buyer* looks like the name of a person.

Buyer isn't a one-size-fits-all category. A buyer may acquire all or part of a company, the stock of a company, or certain or all assets and even assume some of the liabilities. Despite this wide variety of possibilities, buyers typically fall into these four broad types:

- **Strategic buyers:** These buyers are other companies planning to combine operations of the two companies to some extent (as opposed to buying strictly for financial reasons). For example, when Oracle buys a company, Oracle is considered a strategic buyer because it buys companies that have some sort of synergy with its business.
- **Financial buyers:** *Financial buyers* are funds of money that buy companies. Financial buyers of middle market and lower middle market companies are typically private equity (PE) funds and family offices. (See Chapter 12 for more on financial buyers.)
- **Other companies backed by PE funds:** The company will be the new owner of the acquired company, but another entity (the fund) is providing the dough to do the deal.
- **Individuals:** Although it happens, an individual buying a middle market or lower middle market company is rare. When individuals buy companies, those companies tend to be small retail shops, consulting firms, or construction companies. Typically, these companies have revenues of less than $1 million.

REMEMBER

Understanding who is on the other side of the negotiating table can change the way an M&A process works. Are the buyers experienced deal people, or are they new to the process? For example, if a buyer is a PE firm, the seller can probably rest assured that the buyer is sophisticated and knows what they are doing.

Seller

You can't buy something unless you have a seller. Sellers (and by that I mean the actual thing being sold) are companies (or divisions or product lines of a company). As with *Buyer*, *Seller* is often a defined term in contracts (which means it's capitalized with a capital *S*).

Here's a quick look at the types of sellers you may find in the world of M&A:

- **The divestiture:** A company may be selling off a division, a product line, or certain assets.
- **The change of control:** This company is selling enough of itself (more than 50 percent) to result in a change of control. In these cases, the owner or owners most likely receive the money. Colloquially, this approach is called *taking some chips off the table.*
- **The recap:** Sometimes an owner wants to take some chips off the table without giving up control of the company. This situation is called a *recapitalization,* or *recap,* for short. This might mean selling a minority position of the company or it might mean taking a dividend by using the company's balance sheet to borrow money from a lending institution such as a bank or a business development company (BDC).
- **The growth capital:** A seller may issue more stock for the purpose of raising capital to invest in the business. In this case, the owner isn't actually selling the company but rather is selling more *stakes* in the company. The money from the sale doesn't flow to the owner; instead, the company retains the money to fund growth.

REMEMBER

Follow the money: Remembering why the seller is selling the company, how much of the company is being sold, and where the money goes is the key.

Investment banker

Hey! That's me. As I now explain to anyone roped into talking to me, we do nothing with investments and we are not a bank, so, naturally, we call ourselves investment bankers. This is just a fancy term for "I sell companies" or in some cases "I buy companies for others" or maybe even "I raise capital for companies."

A breed of investment bankers exists that will take companies public, but, as Clive Candy might say, that's a whole other kettle of fish. For the purposes of this book, we are focused on middle market M&A transactions. Companies that list shares (go public, in other words) tend to be far larger than the companies that comprise the middle market. And if you're unfamiliar with Clive Candy, look him up! Hint: He's a character in your humble author's all-time favorite movie.

Though a capable investment banker will make a market for a seller (see the section in Chapter 2 about making a market in M&A), the fundamental value of the investment banker lies neither in finding a buyer nor in preparing the materials. Instead, the value lies in closing the deal. Closing the deal isn't necessarily the most time-consuming task. Putting materials together and researching and refining a buyers list take a lot more time. Though those are important steps, the hardest and trickiest work is dealing with all the issues that might pop up as closing approaches. Deals don't close themselves. Someone needs to stay on top of things. Someone needs to push — and often cajole — other constituents to get the deal done.

Transaction (also known as the deal)

The words *deal* and *transaction* are used synonymously: *Transaction* is the fancy term that fancy investment bankers like, and *deal* is the milieu of the common folk. Think of it as the difference between Latin and Vulgar Latin.

What's being bought and sold? In other words, is the seller selling existing shares or issuing new shares? If the owner wants to "take some chips off the table," the owner sells equity (or a piece of equity) to the buyer. The money goes into the pocket of the seller. If the money stays with the company, then new shares (or units) are issued. The owner owns the same number of shares (or units) but owns less of the company on a percentage basis.

The *transaction* takes place when a buyer acquires a company from a seller. It's an abstract concept, as in, "We're working on a transaction that will sell ABC to XYZ." It can also refer to the finished sale: "We completed the transaction yesterday." (Don't confuse the transaction with the *purchase agreement*, a contract that memorializes the transaction. See Chapter 15 for more on this document.)

REMEMBER

Transaction is a more formal version of *deal;* most documents, agreements, and contracts use the word *transaction* (often capitalized as a defined term), but conversations and emails may use *deal* and *transaction* interchangeably. Think of *deal* as *transaction's* popular cousin from the wrong side of the tracks.

Consideration

Consideration is what a seller receives from the buyer as a result of selling the business. In its most obvious form, the consideration is cash, but cash isn't the only way to pay for a business. The buyer may issue stock to the seller in exchange for the business. A seller might accept a note from the buyer. (A *note* is a promise to pay later.) Or perhaps the price of the business is contingent and the buyer pays the seller an *earn-out* based on the performance of the business after the transaction's completion.

REMEMBER

Consideration isn't an either-or situation. In other words, the consideration may consist of some cash at closing, stock in the acquiring company, and an earn-out. Or perhaps the consideration is a note plus an earn-out. No single right or wrong way to structure a deal exists. Structuring a deal by using various forms of consideration is similar to twisting the knobs on a stereo: To get it just right, you may have to increase the bass and turn down the treble. Chapter 12 provides a much deeper dive into the ways buyers can finance deals.

Consideration is usually a defined term and is therefore capitalized in documents and so forth.

Equity

You can refer to equity using two different terms: stock and units. Shares of stock are issued by corporations to the owners of that corporation. Limited liability companies (LLCs) are a little different: LLCs have no shareholders; they have members. And LLCs don't issue shares; they issue units. For all intents and purposes, however, shares and units are essentially the same: an ownership stake in the equity of an enterprise.

REMEMBER

Corporations have shareholders who own stock; LLCs have members who own units.

EBITDA

EBITDA (*e*arnings *b*efore *i*nterest, *t*ax, *d*epreciation, and *a*mortization) is one of those horrible business jargon terms, but it's unavoidable in M&A. EBITDA (and its variations) forms the basis of most deals. In addition to being fun to say (I had a client who once referred to it as "EBITDA dabba do!"), EBITDA is a key M&A metric. Heck, it's a key metric in all things business.

EBITDA functions as a measure of a company's profitability for doing what that company is supposed to do: sell a product or service. EBITDA removes the profit-distorting effects of taxes, interest income, and expense and eliminates the effects of making capital investments in the firm. EBITDA shows the cash the company would generate if it didn't have to pay taxes, borrow money, earn interest on its money, buy equipment, or acquire other companies. EBITDA is a measure of a company's financial performance if that company were in a bubble, sheltered from the real world.

Why is this number so gosh-darn important? EBITDA is often (but not always) the basis a company uses to determine its valuation (see Chapter 6 for more on that topic) and is often a defined term in the agreements and contracts. Banks quite often include EBITDA as one of the covenants for making a loan. (*Covenants* are promises an owner makes to the lender; for example, the company will maintain a certain level of profitability or will not sell off assets.)

TECHNICAL STUFF

EBITDA is commonly pronounced "EE-bah-dah." And in case you're wondering, EBITDA isn't a term from generally accepted accounting principles (GAAP). (Neither is adjusted EBITDA, which I cover in the following section.) However, both EBITDA and adjusted EBITDA are perfectly acceptable terms for the purposes of M&A activities.

REMEMBER

Even though EBITDA is not a Generally Accepted Accounting Principle (GAAP).it is often calculated from audits and reviews (which are GAAP). (GAAP is the accounting industry standard used in the United States; other countries often have similar standards.)

Adjusted EBITDA

Adjusted EBITDA, which is EBITDA's wild-and-crazy cousin, is simply EBITDA with adjustments! For example, a business owner often takes a salary larger than industry standards, so a buyer may want to add back part of that salary to arrive at a more reasonable level of earnings. Say the owner of a company with $20 million in revenue receives total compensation of $500,000 when the industry standard for the president of a like-sized company is $250,000. In this case, adding $250,000 (plus the prorated amount of income tax) back to the EBITDA figure makes sense.

Other adjustments to EBITDA may include addbacks for other owner-related expenses (car, gas, cellphone, country club, and health club, for example). These are expenses that are "added back" (get it? We're so creative in M&A!) to a company's earnings, on the assumption they will not recur after the transaction closes. Other add-backs can include compensation if certain employees will not be part of the business after the deal is complete. Adding back their salaries (and corresponding payroll tax and benefits expenses) is appropriate. The key add-back expenses is to ask: Will these expenses really and truly go away after the owner leaves?

WARNING

Adjusted EBITDA has taken on a life of its own, and though certain addbacks are legitimate, often business owners view adjusted EBITDA as a bottomless pit of adjustments. Here are some actions I've seen that don't work:

» **Every month a different addback:** The buyer is sure to argue that, in the aggregate, the company spends a certain amount month after month. The exact expenses may be different, but the result is the same: an ongoing expense.

- **Firing key management right after the sale concludes:** The buyer will justifiably be concerned about who will actually be in a position to run the company after the transaction closes.
- **Assuming that a buyer will save money after the deal closes — on the condition that certain employees are fired:** The buyer will make the case that the operational savings will be due to the *buyer's* efforts, so why should the seller benefit from what someone else accomplishes?
- **Eliminating commissions or the holiday party or bonuses:** A new owner risks a mutiny if changes to compensation and perks are made simply to improve the bottom line.

REMEMBER

No set standard exists for adjusted EBITDA; adjusted EBITDA is whatever a buyer and seller agree it is. And, just as EBITDA is a non-GAAP term, adjusted EBITBA is also non-GAAP. Quality of earnings (QoE) reports, discussed later in this chapter, are often used to justify adjustments to EBITDA.

WARNING

Although running certain personal expenses through a business may be common, the practice may run afoul of the IRS. Consult with your tax advisor for the proper treatment of personal expenses.

New entity

Okay, *new entity* isn't a term so much as it's the reality of many M&A deals. Many owners think the buyer will buy into the existing company, and though that does happen on occasion, most often a buyer sets up a new entity to acquire the assets of the selling company. Even if a buyer acquires less than 100 percent of the seller's company, a new entity might be set up.

Depending on myriad factors, that new entity might acquire the equity of the seller. Let's say both parties agree to a $10 million valuation and an 80 percent majority sale. The buyer will set up a new entity and acquire 100 percent of the seller (often the assets but sometimes the equity). "How does that work?" you may be asking yourself. The buyer brings 80 percent of the agreed-on valuation, or $8 million, to the closing; the seller gets $8 million plus equity in the new entity worth $2 million.

Rolling equity

No, this isn't a politically correct update to the ubiquitous California roll at a sushi restaurant. Instead, it's a term you might hear in the hallowed halls of M&A when potential buyers start getting serious about making an acquisition. The term means, "Is the seller willing to forgo some cash at closing in exchange for some ownership in the new entity we're setting up?" As with most facets of M&A, rolling equity is neither a good nor bad thing, nor is it required in order to complete a deal. It's just one option among many. (Granted, it's a way for a buyer, who may or may not be faced with limited funding, to help finance an acquisition.)

Leverage

Leverage means debt. Buyers — most often PE firms, unfunded sponsors, or individuals — will likely obtain some of the purchase price by borrowing money. If a seller plans to retain some ownership after the sale, sellers need to be comfortable with the possibility of debt being added to the balance sheet.

TIP

If a buyer plans to use leverage in a deal where the seller retains some ownership (rolling equity!), the seller should make sure the debt *is nonrecourse* — that is to say, the assets of the company back the loan and not the seller's personal assets.

Seller finance

This term refers to the buyer using the seller to finance part (or perhaps all) of the transaction. Rolling equity, as discussed a little earlier, is a form of seller finance because the buyer won't have to obtain the amount of equity being retained (or *rolled!*) by the seller. Depending on the deal, a seller might also be willing to accept a note for some of the purchase price. A note is a promise to pay later. This strategy works well if an owner wants to sell the company to a loyal employee who will likely be a good owner but lacks the funds to buy the company. A note will be issued to the seller, the business will owe the money, and the amount of debt will be recorded as a long-term liability on the balance sheet. The seller will receive payments (likely interest and principal) until the note is paid off.

WARNING

If the buyer is unable to make the payments on a note, the seller, like any creditor, can foreclose on the business and retake ownership.

Closing

Closing is what buyers and sellers dream of! It's why we M&A folks do what we do. Take a look at Chapter 15 if you want more about the ins and outs of what happens at closing. The *closing* is the day when the buyer hands over the consideration to the seller and the seller hands over the company to the buyer.

Considering the Costs Associated with M&A

Although the main cost in any M&A transaction is most likely the cost to acquire the company (or assets), both buyers and sellers incur other costs. These costs range from the retinue of advisors needed to close deals, debt repayment, adjustments made after the close, and, regrettably, taxes.

Tallying advisors' fees and other costs

As I explain in Chapter 10, M&A dealmakers can't do the job alone. Buyers and sellers alike should retain an M&A advisor (investment banker), a lawyer, and an accountant. These people don't work for free, so their charges are part of the expenses of doing a deal. Of course, advisor fees vary based on the deal and how much work the advisor does, but here are some general guidelines:

- A lawyer may charge anywhere from $25,000 to more than $100,000.
- An accounting firm may charge anywhere from $25,000 to $75,000 for an audit or a review. Similar charges will likely apply to quality of earnings reports.
- Investment banking fees vary, but in a very general sense, you should expect to pay roughly 3 percent to 10 percent of the transaction value. The smaller the transaction size, the higher the fee as a percentage of the proceeds.

Some deals involve other costs as well, including a real estate appraisal, environmental testing, a database and IT examination, and a marketing analysis. Fees vary, of course, but all these functions likely cost anywhere from $10,000 to more than $100,000 apiece.

REMEMBER

This section may seem a bit wide open, but nailing down the costs without knowing the deal is impossible. The best way to come up with a concrete estimate of a particular deal's fees is to speak with advisors and ask them to ballpark their expenses.

TIP

If you're worried about fees spiraling out of control, negotiate a flat fee, or a *capped* fee, from your advisors, if possible. Not all will be willing to enter into this arrangement. If you get pushback, you can always agree that if the advisor does the work for a flat fee now, you'll give them the ongoing legal or accounting work post-transaction.

Paying off debt

One area that sellers often overlook is the debt of the business. Unless the assumption of debt is stipulated, a buyer doesn't assume the debt. If a company has $5 million in long-term debt and the company is being sold for $20 million, the seller needs to repay that debt, thus reducing the proceeds to $15 million.

Transactions are usually conducted on a cash-free/debt-free basis. That means any cash on the balance sheet usually belongs to the seller, though third-party debt (bank loans, for example) needs to be paid off.

Making post-closing adjustments

Another area that sellers often fail to consider is the adjustments made to the deal after closing. Most often, this is in the form of a *working capital adjustment,* which occurs when the *working capital* (usually receivables and inventory minus payables) on the estimated balance sheet that the seller provides at closing doesn't match up with the actual balance sheet as of closing that the buyer prepares at a later, agreed-on date (usually 30 to 60 days after closing). The buyer and seller make a working capital adjustment to *true up* (reconcile) their accounts; this adjustment is typically (though not always) minor. If the actual working capital comes in lower than the estimate, the seller refunds a bit to the buyer (often by knocking some money off the purchase price). If the figure comes in higher than the estimate, the buyer cuts the seller a check.

Say that a buyer agrees to pay $10 million for a business, and the buyer and seller agree that working capital has averaged $2 million. If the seller's estimated balance sheet shows working capital in fact to be $1.5 million, the seller has to somehow provide the buyer with (the missing) $500,000. With a working capital adjustment, the buyer just pays the seller $9.5 million rather than $10 million.

The purpose of the working capital adjustment is to make sure the company is operated in the normal course during the due diligence phase. Working capital is an asset, and if less of that asset is delivered at closing, the buyer is due a discount from the agreed-on purchase price (and vice versa). Without a working capital adjustment, a seller would have an incentive to collect all the receivables (even if done at deep discounts), sell off all the inventory, and stop paying bills — thus inflating payables. The buyer would take possession of a business that has been severely hampered by the previous owner.

Planning for taxes

Sellers often forget that they'll likely face capital gains tax on the business sale. That's one reason sellers generally prefer stock deals: A stock deal likely has a lower amount of tax. For many (but not all) sellers, an asset deal exposes them to double taxation: The proceeds are taxed at the time of the sale at the company level and then the owner pays tax on the after-tax amount when the remainder is distributed to the owner. (Chapter 12 gives you the lowdown on stock-and-asset deals.)

TIP

Speak to your financial advisor about your specific tax situation.

Defining Types of Companies

I've written this book primarily for sellers and buyers of middle market and lower middle market companies. What does that actually mean? In a general sense, these definitions refer to the size of the company — specifically, the revenues and profits. Because this is a *For Dummies* book, I'll cut to the chase! Definitions vary, but for the purposes of this book, I've divided the market into neighborhood businesses, small businesses, lower middle market companies, middle market companies, and large companies (and beyond). Table 1-1 defines these companies at a glance; the following sections delve into more detail.

TABLE 1-1 M&A Company Types

Company Type	Annual Revenue	M&A Advisor	Number of US Companies
Neighborhood business	Less than $1 million	Business broker	15 million
Small business	$1 million to $10 million	Business broker	1 million
Lower middle market	$10 to $500 million	Investment banker	200,000
Middle market	$500 million to $1 billion	Investment banker	4,000
Large (and beyond)	$1 billion+	Bulge bracket investment banker	5,000

Source: Adapted from `https://www.naics.com/business-lists/counts-by-company-size/`

Neighborhood business

Neighborhood businesses are companies with revenues of less than $1 million. They're your neighborhood pizza joints, corner bars, clothing boutiques, or small consulting or accounting practices.

Although these businesses are viable *going concerns* (they aren't facing liquidation in the near future) and often trade hands, they're too small to be of interest to PE firms or strategic buyers (flip to the earlier section "Buyers" for more on these kinds of buyers).

Why are sole proprietorships of little or no interest to an acquirer? Simply put, buying a $1 million business and a $100 million business requires about the same amount of time and the same steps and expenses, so if you're going to take on the trouble of buying a company, you may as well get your money's worth and buy a larger concern. Making dozens of tiny acquisitions is just not worth the time or expense.

Small business

Small businesses usually have annual revenues of $1 million to $10 million. These businesses are larger consulting practices, multiunit independent retail companies, construction firms, and so on. Unless the company is incredibly profitable (profits north of $1 million, and preferably $2 million or $3 million), small businesses are too small to be of interest to most strategic acquirers and PE funds.

TECHNICAL STUFF

Although PE funds and strategic acquirers are usually not interested in smaller companies, they occasionally make exceptions if a company has a unique technology or process. In these cases, the acquirer can take that technology or process and deploy it across a much larger enterprise, thus rapidly creating value.

Middle market and lower middle market company

Lower middle market companies have $10 million to $500 million in annual revenue; *middle market companies* have revenues of $500 million to $1 billion. These companies typically have enough critical mass to be of interest to both strategic acquirers and PE funds. Also, because these deals are larger than small business and sole proprietorship deals, M&A transaction fees are large enough to justify the involvement of an investment banking firm.

Large company (and beyond)

Companies with revenues north of $1 billion are considered large, huge, gigantic, and, if revenues are well into the billions, Fortune 500. Although transactions are typically very large, the fact is that few companies are large. The middle and lower middle market segments are far larger.

Firms in this category typically use *bulge bracket* investment banks. These entities are the largest and most sophisticated of investment banks. They also charge enormous fees.

TECHNICAL STUFF

The term *bulge bracket* originates from the placement of a firm's name on a public offering statement. Public offerings of securities typically involve multiple firms, and the largest firms, or managers of the offering, want their names to the left, away from the names of the smaller firms. The placement of the names looks as though they were bulging — hence, the moniker.