MERGER & ACQUISITION FOCUS

April/May 2005

Recognize legitimate red flags during the due diligence process

The problem with internal rate of return

Heading off the postmerger integration blues

Ask the Advisor

Recognize legitimate red flags during the due diligence process

Due diligence is the process of determining whether representations — legal, financial and otherwise — made by a seller are true and whether the buyer's proposed bid is fair based on these representations. The purpose of due diligence is to uncover weaknesses or uncertainties that might prevent the transaction from meeting a buyer's desired goals.

In today's post-Enron environment, companies considering a merger or acquisition must devote considerable time and energy to performing due diligence. But novice buyers may feel uncomfortable with the process, unsure of what to look for and what might constitute a legitimate "red flag." That's why it's important to staff your due diligence team with professionals experienced in merger and acquisition issues.

A team approach

Traditionally, due diligence teams featured lawyers to examine contracts and look for potential liabilities and other legal issues. Accountants and other financial advisors were available to analyze financial data. But increasingly, companies are also adding market research professionals to provide guidance on marketing-related issues, and private investigators to perform extensive background checks on the company and its management team.

Today, due diligence needs to include issues barely considered several years ago, including a company's brand value and the value of other intangible assets, along with the company's and management's reputation. A multidisciplinary team is most likely to look at a deal from various angles and spot problems before they have a chance to explode and destroy the deal farther down the road.

While due diligence can turn up many types of problems, probably the most critical is evidence that the seller has made false material representations. Depending on how negative they are, false representations may be grounds for reducing your offer price, adjusting the terms of the deal or terminating it altogether.

Issues that warrant concern

Sellers occasionally make unintentional mistakes or omissions, but experienced due diligence professionals can generally identify patterns that suggest innocent errors are, in fact, willfully misleading statements. Certain types of issues will alert your due diligence team that trouble may lie ahead.

Results inconsistent with industry peers'. In 2000, Enron reported revenues of $100 billion — a 150% increase over the previous year, while the second-ranked pipeline company reported revenue increases of less than $30 billion. This should have tipped off investment analysts. If a company's financial performance is much better than that of its typical industry peers with similar operations, something is likely to be awry.

Financial results that seem too good to be true or are statistically implausible should similarly be scrutinized

for false representations. Even if the company's financial representations are legitimate, this may be a sign that the target's management, business model or strategy is highly unusual, even unparalleled. This could make it very difficult for you to reproduce the company's success under a different management or operational structure.

Improbable financial statement changes. Your target's financial statements should be presented according to generally accepted accounting principles (GAAP) and be consistent with industry norms.

The due diligence team should scour financial statements for unusual balance sheet changes or trend reversals, such as receivables growing faster than revenues. The team will want to pay particular attention to disproportionately smaller changes in cash flow vs. earnings.

Complex business models. Overly complex organizational structures involving unusual legal entities, numerous managerial lines of authority or contractual arrangements without apparent business purposes are all signs that additional due diligence is warranted. Simple reporting structures and legal entities are usually best. If your due diligence team spots complex business arrangements that cannot be explained easily, or that appear counterintuitive, they may be just that.

Remember, financially distressed businesses under threat of bankruptcy or foreclosure face enormous temptation to cook the books and occasionally they succumb. Financially troubled firms, therefore, warrant an extra level of scrutiny.

Questionable management background. Often, due diligence inquiries into the backgrounds of the target company's management team are limited or superficial. This is particularly true when the buyer and seller have an existing business relationship or are social acquaintances.

The professional members of your due diligence team can be especially helpful in this regard. They are capable of performing objective and rigorous background searches using public records to unearth such important information as past litigation, criminal complaints or inaccurate resumé items.

Criminal convictions or even false academic credentials should make you think twice about retaining such an individual after the deal closes. You will also want to question any financial results the executive had a hand in.

The seller's due diligence role

Due diligence is just a buyer's responsibility, right? Not necessarily.

While buyers shoulder a greater burden during the due diligence stage, sellers also need to actively participate in the process. If you're selling your business, you should realize that due diligence is a crucial phase of the acquisition's life cycle, not the time to get complacent. Depending on the issues your buyer raises, as well as the buyer's negotiating style, the deal's terms may be significantly renegotiated at this point.

Get ready for due diligence by assembling a "war room" at the onset of the sale to organize all the information your buyer is likely to request. This information must be consistent with any verbal or written representations made by members of management.

At a minimum, you should assemble a complete set of financial statements and tax returns for the previous five years. You also need to be able to support any nonrecurring or exogenous restatements to the income statement such as "excess" managerial compensation.

Due diligence is your chance to prove your credibility to the buyer, so be prepared, cooperative and completely honest. This will help the deal proceed more smoothly and enable you to get the best possible price and terms.

The team may also be able to set up confidential interviews with a broad sample of the target's employees for signs of poor morale, lack of confidence in existing management or even ethical lapses.

More rigorous and more efficient

While the issues analyzed by today's due diligence team are greater in number and complexity than those of a decade ago, the process has actually become more efficient.

Now, sophisticated analytical software and information-gathering systems make legal, financial, operating and managerial due diligence reviews faster and more economical than in the past. What's more, there are plenty of experienced professionals available to help you get the information you need to complete your transaction.

The problem with internal rate of return

Internal rate of return (IRR) is a financial calculation commonly used by executives to evaluate and prioritize investment decisions. Unfortunately, by not being aware of the fundamental limitations of IRR calculations, many companies actually make unprofitable or otherwise inappropriate choices.

Misleading assumptions

As finance textbooks have long warned, reinvestment assumptions built into typical IRR calculations frequently lead to overstating returns.

Considering how frequently IRR is employed — two Duke University researchers found that 75% of the chief financial officers they surveyed always or almost always used IRR when evaluating capital projects — this can be a significant problem. This is particularly true when IRR calculations are the main criteria for pursuing a merger or acquisition.

On a basic level, IRR is considered the annual equivalent economic return for a given investment. One of its fundamental assumptions is that interim returns can be reinvested at the same rate in the company's other projects — something that isn't necessarily true for many businesses.

By not being aware of the fundamental limitations of IRR calculations, many companies actually make unprofitable or otherwise inappropriate choices.

IRR, therefore, is a true indication of a project's annual return on investment only when the project generates no interim cash flows or when interim cash flows actually can be invested at the calculated IRR. The greater the deviation in reinvestment returns from the original IRR, the greater the error rate of the calculation.

Identical IRRs, different returns

These sometimes faulty assumptions about reinvestment can lead to investment mistakes. Consider this hypothetical assessment of two different acquisitions: Target companies A and B have identical cash flows, risk levels and calculated IRR values (30%). While these targets appear identical, a difference in their interim cash flows could make one much less attractive than the other.

Suppose that A's interim cash flows can only be reinvested in projects that will yield a 10% annual rate of return. In contrast, B's cash flows can be reinvested back into the company and continue to yield a 30% annual rate of return. Investment B, which reinvests the interim cash flows at the calculated IRR yield, is, therefore, preferable to A, even though their initial IRRs are identical.

As long as the interim cash flows are being reinvested at the original rate, the actual IRR will equal the forecasted

IRR. But acquisition investments, for example, generally produce periodic returns and these cash flows are reinvested at a different IRR than those of the acquiring company. Unless IRR calculations are modified to account for this aspect of reinvestment rate risk, merger and acquisition IRR calculations will probably be overstated.

Solutions to the problem

This doesn't mean IRR is useless. If you understand the metric's limitations, you can develop techniques to modify it and improve its accuracy. A modified internal rate of return (MIRR) can help you set more realistic interim reinvestment rates and, therefore, calculate a more accurate annual equivalent yield.

Modifying the IRR calculation is not particularly difficult. You simply assume periodic returns will be reinvested each year at a different — most likely lower — rate of return than that of the original IRR calculation.

Executives who review projects that seem to have an attractive IRR should ask the following questions:

1. *How sensitive is the IRR calculation to reinvestment returns?* The greater the sensitivity of the IRR calculation to reinvestment cash flows, the greater the calculation is distorted. One solution is to model the interim cash flows at the company's cost-of-capital rate.

2. *Are interim cash flows biased toward the beginning or the end of the project?* Given reinvestment rate assumptions, the IRR will be increasingly distorted the earlier the interim cash flows occur. The gap between the actual reinvestment rate and the assumed IRR exists for a longer period of time, so the impact of the distortion grows. While you may prefer a cash payback sooner rather than later, it's actually better to receive returns later.

Recognizing limitations

Because of its strong intuitive appeal and the fact that many executives are already familiar with the metric, IRR use is likely to remain widespread. To avoid making poor investment decisions, view IRR numbers — especially when assessing potential merger targets — with some skepticism and recognize their limitations.

Heading off the postmerger integration blues

Most research on why mergers and acquisitions ultimately fail name poor postmerger integration as a major factor.

While valuation and pricing will obviously influence the success of your deal, inefficiently and ineffectively

integrating the two companies can dwarf any mistakes made before the deal closed. Participants, therefore, need to make substantial postmerger plans and put them into action well before the deal closing date.

Furthermore, many companies do not take into account the cost of integration when calculating returns on an acquisition. Understanding integration needs early in the process will assist in determining the associated costs.

Create an integration team

While it's important to make integration plans quickly, keep in mind that you have only one chance to get it right. Don't sacrifice good judgment and carefully laid plans for speed. To ensure the best results, form an integration team made up of managers from sales, marketing, operations, finance, human resources and public relations.

For most companies, forming an integration team may prove somewhat challenging since many team members have other responsibilities. It is important, therefore, to prioritize integration team duties and give members time to focus on this important project.

> *In addition to effectively communicating internally, you need to share information with external stakeholders, including customers and vendors.*

This team will plan all postmerger integration issues relating to:

- Internal and external communications,
- Management structure of the combined organization, making sure that meritocracy prevails and the combined organization selects the best people from each company for every position,
- Staffing changes, including potential reductions and new hiring,
- Compensation and benefits,
- Facilities issues, particularly whether certain offices or production sites will close,
- Operations issues, including combining business units,
- Changes in sales routes or territories, and
- A shared corporate culture that focuses on team building.

While drawing up its integration plan, the team should regularly communicate with employees and advisors who are performing due diligence on behalf of the merger. Ideally, the integration team leader should also be a member of the due diligence team. This way, the integration team will know about issues that might change the nature or timing of the deal — such as misrepresentations of information regarding operations or personnel — early in the process.

To be effective, the integration team must be provided with the tools necessary to implement the combined organization. These include adequate financial resources, proper staffing and access to important data.

Communicate internally, externally

Few things will destroy integration plans faster than poor communication. Employees of both companies are likely to worry that a merger will mean either the loss of their jobs or significant changes in their responsibilities or compensation.

To quell these fears and the rumors that often attend uncertainty, company leaders need to quickly communicate the merger and integration plans and what they will mean for employees. Once employees are reassured, they can get back to work and focus on maximizing the benefits of the merger.

If you're making an acquisition, it's essential that you enlist the support of the managers of your target company. Rank-and-file employees will take their cues from their company leaders. Unless these individuals buy in to your acquisition deal or integration plan, you risk losing productivity and key personnel.

If you're the selling owner, you may want to consider offering stay bonuses — retention incentives such as accelerated vesting in stock options — for key employees to remain with the company at least through the deal closing.

In addition to effectively communicating internally, you need to share information with external stakeholders, including customers and vendors. Each group will have specific concerns, so it may be helpful to create a comprehensive question-and-answer document that anticipates those concerns and ensures that various members of your company provide consistent replies to outside inquiries.

Plan for the long haul

Postmerger integration is a complex operation requiring extensive planning. It's also a long-term process that may take several years to fully realize; you won't simply be able to disband your integration team once the deal goes through and the two companies merge. Instead, prepare for the long haul, knowing that unanticipated issues are likely to arise and that you will need a knowledgeable team to deal with them.

Q. What is a second lien loan and how might it help me make an acquisition?

A. Junior secured second lien loans were introduced in the late 1990s to bridge the gap between the amount of credit available in the senior secured loan market and the amount that borrowers may need for their business plans. While not a widely offered product, more and more banks and specialty finance companies are making it available.

Early on, second lien loans were used by companies that were restructuring their debt because of decreasing cash flows. Loan amounts were initially small and many of the deals were underwritten based on the excess of the market value of the borrower's total assets.

Companies that are asset rich but cash-flow poor can potentially benefit from second lien loans. Second lien loans work in tandem with asset-based loans, with the same bankruptcy protection rights and similar covenants requiring borrowers to achieve financial goals, or refrain from doing certain things such as accepting additional debt.

The only major difference is that second liens are junior in repayment priority to senior loans (but are, nevertheless, secured). They rank ahead of trade payables, subordinated debt and other contingent liabilities, however.

Because these products have only recently emerged as a true asset class, the market remains relatively small — though it is expanding.

Secured second liens are generally structured one of two ways. In the first case, the second lien loan shares in the aggregate collateral of the company. This means the borrower's senior debt is secured by all assets, while the second lien relies on excess collateral from the same collateral pool (similar to a home equity loan).

In the second instance, the loan bifurcates the collateral, meaning the first and second liens are secured by discrete pools of collateral. Senior debt might be secured with working capital assets, while the second lien relies on less liquid assets such as real estate, plant and equipment, or even trademarks, trade names and patents.

Given the relatively early stage of the market, pricing on second lien loans varies widely. Some are set at a fixed rate, while others offer floating rates. Since these loans are commonly used as part of a refinancing, they feature the same length as senior secured financing — usually between three to five or five to seven years.

Second lien loans can provide much-needed flexibility to companies that qualify for this type of financing and give companies time to improve cash flow. This type of transaction is, therefore, best suited to asset-rich firms with sufficient collateral, but insufficient cash flow to support larger loans.

Additionally, second lien loans provide an alternative to even more expensive forms of capital, such as subordinated debt and equity. The rates on second lien loans are typically lower than those on mezzanine debt, as well as equity. And because second lien investors generally don't ask for warrants (the right to buy a certain percentage of a company's stock), businesses don't have to dilute their equity.

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2005 MAFam05