

# Merger & Acquisition Focus



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# Don't fumble your acquisition

## HIDDEN RISKS COULD TAKE YOU OUT OF THE GAME



To help ensure a successful M&A deal, buyers need to think about and investigate risks that could diminish the transaction's value or even destroy it altogether. Risk management due diligence can identify issues early and enable you to devise a game plan for tackling them head on. Then M&A insurance can protect you from the unknown risks you aren't able to uncover during due diligence.

### Game plan

Even before you begin due diligence on a potential acquisition, it's important to assess the seller's risk profile — an analysis of likely risk scenarios, outcomes and corrective

actions. You then can make an informed decision about whether you're willing and able to handle the risks, and what it will cost in time and money to remediate them. At the same time, look into the sellers' motivations to determine why they no longer want to own and operate the company.

*Even the best due diligence won't reveal every potential risk. That's why M&A insurance is available.*

When you move on to the due diligence stage, include risk-management issues on your review list. Uncovering risks during due diligence not only helps you avoid an acquisition you'll regret, but can give you more bargaining power during price negotiations if you choose to buy the company despite its risks. If you find, for example, litigation threats or inadequate insurance coverage, you can factor these risks into the deal and possibly offer a lower price. It's then up to the seller to mitigate those risks or accept the lower offer.

### Due diligence checklist

To head off unpleasant surprises later, you'll need to review a range of potential problem areas during due diligence. This includes:

- ❖ Insurance coverage, including whether all policies are still in force,
- ❖ Accruals for outstanding liabilities such as accounts payable,
- ❖ Prior acquisitions and divestitures that might carry assumed or future liabilities,
- ❖ Potential contractual liabilities,
- ❖ Liens on property,
- ❖ The likelihood of litigation or pending action,
- ❖ Contentious management or employee situations,
- ❖ Customer complaints and frequent product returns or reimbursements,
- ❖ Lease agreements that may contain undesirable terms,



- ❖ Political or regulatory risks, and
- ❖ Environmental risks.

You'll also want to find out how much funding the company has made available to implement risk management programs.

Because there's so much ground to cover, enlist the help of your M&A professional. This expert can work with you to develop a comprehensive due diligence checklist of items specific to the company you're seeking to buy.

### Offensive plays

Even the best due diligence won't reveal every potential risk. That's why M&A insurance is available. Policies can cover everything from breach of representations and warranties outlined in the buy-sell agreement to tax, employee benefit, accounts receivable, environmental, and other unknown liabilities. M&A policies also reduce the need for large escrow accounts and holdbacks.

Depending on your needs, you might consider the following types of policies:

**Representations and warranties.** This covers exposure related to the representations and warranties a seller makes to a buyer. Public companies usually buy this insurance when they acquire private companies or spin-offs of other public companies.

**Aborted-bid.** This type of policy pays transaction costs, except break-up fees, if the deal doesn't go through. Transaction costs include fees for consultants, attorneys, investment bankers and public relations experts.

**Tax opinion.** When an acquired company's business strategy is built on a specific tax opinion, this policy

reimburses buyers for expenses that might be associated with a change or reversal of the opinion.

**Successor liability.** This protects a buyer that assumes the liabilities of the acquired company. It shields buyers from losses due to claims that hadn't yet been filed at the time of the acquisition.

**Loss portfolio transfers.** This allows an insurance company to take over risk from real or potential liabilities — such as large self-insurance losses — on the target company's balance sheet.

### Playing to win

Most things that promise great reward involve at least some risk. M&A deals are no different. But early assessment and management of associated risks can help turn a potential fumble into a winning touchdown. ■

## The biggest acquisition risk

Acquisition risks aren't limited to litigation, financial liabilities and other issues that would require large cash outlays. Perhaps the greatest risk of any acquisition is that it won't accomplish the objectives that motivated it in the first place.

Before you seriously consider buying another company, take the time to identify your strategic goals — such as cost synergies, greater geographic reach or the introduction of new products. Then determine if making an acquisition is likely to help you accomplish them, or if there are other, less expensive and less time-consuming strategies you might pursue instead. These could include a strategic partnership with a company that has complementary products or services or an initial public offering.

If you do decide to buy another company, make sure you've considered the additional risks and costs of a combined entity that may not have been present when the two organizations operated independently. For example, the merged company could, with its increased market share, receive regulatory attention about possible antitrust issues. Or it might be necessary to make expensive technology upgrades so that your company can take advantage of some of the assets you've gained through the acquisition.

# How collars can help ensure the value of your M&A deal

**F**or many M&A deals, the period between the announcement of the merger and the transaction close can be tense and tumultuous.

This is especially true for stock-financed deals. If the buyer's stock price fluctuates significantly, it can alter the deal's terms and even threaten to derail it altogether. On the other hand, if buyers and sellers can agree to a stock price range — or “collar” — they can protect the value of the deal even as share prices fluctuate.

## What's at stake

Unlike all-cash deals, where the transaction value typically remains constant, deals financed partially or entirely with stock can decline in value as the buying company's share price fluctuates. This, in turn, complicates the deal because parties may need to renegotiate price as they approach closing.

*With a collar agreement in place you're likely to reduce negotiation time and costs at closing.*

Typically, a seller's shares are exchanged for a fixed number of the buyer's shares in a deal structure called a *fixed exchange ratio*. This arrangement, however, can work against the seller if the buyer's stock declines substantially before closing. Conversely, a fixed exchange ratio can work against the buyer if its stock price increases, because it then will have a higher price-per-target share than it had originally negotiated.

## Safeguarding the deal

By setting floors and caps on the stock portion of an acquisition's price, a collar gives both sides some assurance that the deal will retain its value. There are a variety of collar types from which to choose. The one that's best for both parties will depend on your primary concern — whether it's maintaining a certain percentage ownership or securing a specified target price.



Two major types of collars are:

**Fixed-value collar.** Here both parties agree on an acceptable price range for either party's stock to remain within, or the “collar width.” The exchange ratio adjusts within the set pricing parameters and won't fall below the floor or above the cap.

**Fixed-share collar.** In this case, the buyer agrees to give a specific number of its shares for each seller's share, and the parties agree on a pricing range for those shares. The deal's value fluctuates based on the price of the buyer's stock. A fixed-share structure lessens the risk of buyer overpayment because the exchange ratio decreases once prices exceed the highest price in the range.

## Chance to walk away

Some collars are designed to limit risk by allowing the buyer or seller to walk away if stock fluctuations make the deal undesirable. There are two types of collar offers:

**Fixed-collar offer.** The originally negotiated stock-for-stock exchange ratio doesn't change, but either party can cancel the deal if the buyer's share price moves above or below a specified level. Fixed-collar

offers are most appropriate when sellers are willing to accept some uncertainty about the amount of the final sale proceeds.

**Floating-collar offer.** Here, the exchange ratio may change within a specified range up until closing, but the price remains the same. The upper boundary protects the buyer from shareholder dilution if its stock falls between the initial agreement and the close of the deal. The lower boundary protects the seller from a reduction in ownership of the combined entity.

Although they can limit risk, collars have potential drawbacks. They may make a deal more complex and increase the time that management spends up front negotiating terms and price parameters. On the other hand, with a collar agreement in place you're likely to reduce negotiation time and costs at closing.

### Case in point

To understand how a collar might help mitigate risk, it helps to look at a transaction that successfully used one. Toy manufacturers Mattel and Learning Company

entered into a merger agreement in which Mattel agreed to acquire Learning for \$33 a share in stock, for a total value of \$3.8 billion.

If Mattel's shares had fallen below \$33 by closing, it would have had to give more shares to Learning than originally agreed upon — causing a dilution of Mattel's earnings. Conversely, if Mattel's share price had substantially risen, Learning shareholders would likely have received many fewer Mattel shares and owned less of the combined company.

Neither of these scenarios occurred because the parties used a fixed-value collar, which set the stock's price when the original sale agreement was made. Ultimately, the amount of stock exchanged was determined by the buyer's stock price when the transaction closed.

### Assess your risk

There's no one-size-fits-all collar for every transaction. You need to weigh your goals for the merger, assess the potential risk and discuss price protection strategies with your M&A advisor. ■

# Staying power

## RETAIN CUSTOMERS AFTER AN ACQUISITION

**W**hen a company is acquired, its loyal customers may feel uncertain about the new owners — uncertain enough to take their business elsewhere. It's important, therefore, to start making customer-retention plans early in the acquisition process. It will go a long way toward allaying customer fears, thwarting predatory competitors and ensuring the business's postdeal profitability.

### A proactive approach

Focusing on customer relationships during and just after an acquisition is critical to successful retention. While it used to be standard to lose a certain percentage of customers, attrition should no longer be considered an inevitable byproduct of an M&A transaction. By recognizing the causes of attrition — such as pricing, product changes, lower service levels and rebranding — and making a plan to address them, you can retain your target's customer base.

It's important to be proactive. When, for example, CVS Corp. bought more than 1,200 Eckerd drugstores in 2004, it launched a major marketing and advertising campaign to introduce itself to Eckerd's customers. It also donated \$20 million worth of Eckerd-branded products to a hunger-relief program — a gesture that generated goodwill for the company in its new markets.





### Simple retention strategies

Even if you don't have the budget for a large-scale marketing campaign, you can help make a good first impression and build a positive relationship with your acquisition's customers by implementing some relatively simple strategies:

**Do your research.** Customer relationships sometimes are neglected in the due diligence stage of an M&A deal. But it's imperative that you know why customers do business with the company you're buying. Is it price? Quality? Customer service? Relationships with owners or key management? And will your combined organization still be able to meet customers' needs? Be sure to conduct adequate research into these customers' needs well in advance of the deal's close so you can devise a strategy for meeting them.

**Keep key employees onboard.** What would happen to your acquisition's customer base if a marketing director, key product developer or lead salesperson resigned? It could result in the loss of valuable customers. With the seller's advice, develop appropriate incentive plans to retain important employees through the transaction and after the deal closes. But be wary of employees who stay onboard physically, but check out mentally. Unmotivated and unproductive employees can undermine your new organization — particularly if they have frequent contact with customers as sales or customer-service staff.

### Put the new sales team to work.

Make a plan that details how the combined company's sales force will begin promoting the new organization and selling its products and services. Be sure to implement it as soon as possible after the deal closes — delays can provide a window of opportunity for competitors.

### Keep lines of communication open.

Ensure that customers are at ease with the transition by, as soon as feasible, explaining to them your merger plans and what they can expect in the near and long term. Customers want to know who will be handling their accounts and what changes will affect them — particularly those relating to pricing. Also, give customers an opportunity to provide feedback and voice

concerns, through, for example, regular conference calls or client surveys.

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**Add value.** One of the best ways to retain customers is to offer them better value. After buying the Eckerd stores, CVS invested an average of \$350,000 per store for upgrades, additional customer service staff, increased operating hours and reduced pharmacy wait times. It also earmarked 5,000 items for price cuts. Based on your products and customers, determine ways to add value that will be appreciated. These might be anything from streamlined billing to frequent-customer rewards programs.

### Secret to a successful acquisition

Effectively retaining your acquisition's customers can mean the difference between a successful acquisition and one that's doomed to fail. Determine early on how you'll meet the needs of these customers, and you'll be more likely to retain most of them. ■

# Ask the Advisor

*Q: Should a business seller always accept the highest bid?*



**A.** In most M&A deals, the sale goes to the highest bidder. But sometimes the buyer offering the most money doesn't provide the best value overall for a selling company. In fact, sometimes it makes sense to accept a lower offer from another bidder.

## Settling for less

There are several reasons why a seller might refuse a deal with the highest bidder. One of the biggest is risk. For example, if a buyer's financing appears to be shaky, the deal could unravel as it approaches closing. In this case, a bidder offering less, but standing on firmer financial ground, may be a better bet.

Similarly, if the highest bidder's acquisition is likely to be challenged by government regulators, going with a lower bid from a company not likely to draw regulatory interest could mean fewer hurdles. It also may provide greater assurance that the deal will go through.

The deal structure can affect risk, too. Sellers typically prefer cash over stock deals because they involve less risk. If the highest bidder proposes

a transaction largely financed with company stock, the seller risks the share price dropping before the deal's close or after the merger of the two organizations. If a seller does agree to a stock deal, it might ask for more shares or request a collar (see "How collars can help ensure the value of your M&A deal" on page 4) to protect against increased risk.

Finally, the seller may not be able to reach a consensus with the highest bidder on critical issues — such as the value of intangible assets or securities such as preferred stock and restricted stock. Disagreement over the number and extent of liabilities, including potential litigation, environmental exposure and regulatory issues, can also make what seemed like an attractive offer unworkable.

## Look at the big picture

While price is important, sellers — particularly if they're accepting stock as part of the deal — need to focus on the big picture and consider:

- ❖ The likelihood of successful integration,
- ❖ Whether the company cultures are compatible, and
- ❖ Whether the synergies the buyer anticipates actually exist.

The ease with which the two companies merge will greatly affect the new organization's profitability. Failure to integrate smoothly, in fact, is often cited as the major reason mergers fail.

## Overall value

When selling a company, getting the highest price is the ideal. But considering the complexity of most M&A deals — including valuation, deal structure and the difficulty of reaching agreement about specific details of the transaction — it doesn't always make sense to accept the high bid. Sellers need to consider the bigger picture when weighing offers. ■

