

# **STRATEGY AND SYNERGY: VITAL ELEMENTS OF THE DEAL**

**BEST PRACTICES OF THE BEST DEALMAKERS  
2014**

Introduction by  
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*“In M&A, the playbook for virtually all participants, whether corporate or financial, is now strategic.”*

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## INTRODUCTION

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**D**rawing on the experience and expertise of the “best in class” dealmakers, The M&A Advisor (<http://www.maadvisor.com>), together with the leading provider of virtual deal management services, Merrill DataSite® (<http://www.datasite.com>), publishes the quintessential dealmakers guide series – “**The Best Practices of The Best M&A Dealmakers.**” Profiling the proven strategies and unique experiences of the leading M&A practitioners, “The Best Practices of The Best M&A Dealmakers” series is distributed in regular installments for M&A industry professionals in both print and interactive electronic media. Previously published features and chapters are also available in the online library of Merrill DataSite and The M&A Advisor. We are pleased to present **Strategy and Synergy: Vital Elements of the Deal.** This installment discusses the best practices for formulating an M&A strategy in order to help ensure the appropriateness of an acquisition or a sale in terms of the synergies to be realized as the transaction’s end product. On the following pages you’ll find helpful observations provided by candid interviews with leading dealmakers, including buyers, sellers and advisors, as well as timely insights into the most current trends.

*“Now we are all strategists.” - Marshall Sonenshine*

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## Strategy and Synergy: Vital Elements of the Deal

### Introduction

**I**n M&A, the playbook for virtually all participants, whether corporate or financial, is now strategic. Things were not always this way. Bankers who came of age during the halcyon days of leveraged finance generally ran two playbooks in tandem: Strategic and Financial.

The Strategic playbook asked the question about which corporate buyers could acquire a company and what changes would they make to the company's management, strategy or operation, to add synergy value that would justify the strategic price that the target company would cost. The Financial playbook asked how can we change the capital structure of the firm, principally through leverage, to cause the firm to focus more intensively on cash flow for purposes of reducing leverage and enhancing equity value over time. Private equity-led buyouts trace their origins to this simple playbook.<sup>1</sup>

The second playbook, while not extinct, is less useful today than in the past. Today, Financial buyers must think strategically because most acquisition prices are too high to rely solely on financial engineering to generate excess returns above public market equivalents. In the early years of this transition, private equity firms began adding operating partners to their ranks, drawn from industry, to help improve portfolio companies operationally and strategically, thus enhancing revenues and profits. As they added operating partners, PE funds developed sector expertise and core competency expertise towards strategic value enhancement. Highly interventionist funds have tended to generate higher returns than those that relied on the principally financial engineering.

Some firms, such as top quartile players Warburg Pincus and New Mountain Capital, began to be known for less leverage and more direct intervention. Some top performing sector firms like software-and-tech focused Vista Equity Partners became known for in depth intervention into management and compensation incentive arrangements as part of their value proposition – and

1. See M. Jensen, “Eclipse of the Public Corporation,” Harvard Business School (1989).

delivered top-tier results. Those that adapted to the new era of strategy driven investing fared better; those that clung to old 1980s and early 1990s style playbooks often fared less well. Over time, virtually all got religion: private equity firms became stewards of strategic as well as financial value. Among PE firms today, one hears almost constant references to “platform companies” since one of the mandates of acquisition is strategic follow-on dealmaking.<sup>2</sup>

Alongside this convergence of financial and heightened strategic thinking for private equity buyers, corporate buyers similarly have become hyper-focused on strategic change, to an even greater extent than in the past. For one thing, the era of the diversified corporate buyer has largely receded, other than for a few holding companies known for this, such as Berkshire Hathaway, GE and Leucadia. Today’s equity markets have a decided preference for purer plays, as evidenced by the spinoffs conducted by companies as diverse as Time Warner, News Corporation, Thomson Reuters, and many others. In the world of purer plays, acquisitions have had to be increasingly about synergies, not diversification. Further, equity multiples have increased generally in the seven years of cheap money driving equity markets up post the 2008 financial crisis; in this context, equities are pricey and equities with premia are very pricey, and so acquirers are under heightened pressure to find strategic synergy value.

Thus, on both sides of the old Strategic/Financial divide, now we are all strategists. Further, the M&A market itself is now considerably more driven by corporate than PE buyouts: financial dealmaking constituted some 30% of global mergers pre-2008 Financial Crisis, but in the years since then both aggregate deal volume and the percent attributable to financial buyers have declined – and as noted, even financial deal making now includes a heavy dose of strategic investment logic. Hence, the brave new world of M&A is actually a return to an older world of corporate mergers: the deal is about strategy.

All this raises the question, what is strategy and how do deals enhance strategy? There are many definitions to each of these, and as a 28-year veteran of the industry and a longstanding professor at Columbia Business School I am happy to add my own sense of these broad concepts. For these purposes, corporate strategy is the art of configuration; that is, how one configures a company to optimize its performance within that sector. By configure we mean not merely capitalization, nor even management, but what business assets are organized around what business relationships and game plans so as to win both the battle for market share and the war for shareholder value.

2. See D. Klier, M. Welge and K. Harrigan, “The Changing Face of Private Equity: How Modern Private Equity Firms Manage Investment Portfolios,” *Journal of Private Equity* (Fall, 2009).

To navigate these heady issues, one must deal with not just finance but also commerce – questions around management, product development, sales and marketing, competition, operations, technology, strategy. One can no longer be a dealmaker in a financial silo; one can only be a dealmaker in a far more complex and multi-dimensional business matrix. A few sector examples will illustrate the strategic trend.

In today's media markets, media conglomerates have largely recognized a failure of synergy between publishing and broadcast, and accordingly have disaggregated into those corporate entities. Within each, they are seeking to enhance those assets, with management teams and new content distribution arrangements organized accordingly. Thus, Comcast has grown, first through the acquisition of NBC, and more recently, the proposed acquisition of Time Warner Cable. On the flip side, Tribune has shrunk, through the separation into a publishing group and a broadcast company, each of which must now find new ways to compete. More dramatically, the Washington Post company has sold its flagship newspaper to digital and e-commerce leader Jeff Bezos (who will presumably change the model of the newspaper in some strategic ways), leaving behind a media company still called the Washington Post that no longer owns *The Washington Post*.

One finds similar trends of strategic combinations across virtually all sectors. Post financial crisis, financial institutions have restructured. Healthcare, constituting a whopping 18% of GDP in the US, invited both regulatory reform through the Affordable Care Act and corporate reorganizations through countless mergers in virtually every subcategory from insurance and managed care to pharma, electronic health records and hospital groups. In energy, landmark M&A dealmaking has arisen in response to global recession, commodity price reductions and demands for both American energy independence and alternative energy sources. Indeed, most of the resumed growth in global M&A – approaching \$2 trillion in the first half of 2014 – is attributed to corporate strategic deal making. Further, even the flagship big financial buyouts of the past year or two, such as 3G's \$28 billion purchase of Heinz and the \$25 billion Dell Inc. privatization, appear to be referenda on not how quickly debt can be repaid by ordinary operations, but to what extent new business strategies can deliver new sales and profits.

In this brave new strategic context across sectors, dealmakers are strategists or they are out of business. Virtually all M&A is now strategic, even if your

client or counterparty is a financial firm. That means going back to basics of vertical and horizontal analysis of markets, industry mapping, cost and price assessment, testing marketing strategies against market share statistics, five forces, Six Sigma, and any other strategic tools that modern business thinkers have developed. Is this a good thing? I would argue it is, but it almost does not matter, because markets are neither good nor bad but just plain are – one deals with markets as one finds them, and today we find them hyper-focused on business strategy.

I look at our own firm's recent deals in the last few years, and they are remarkably typical of these trends. We merged a German industrial software simulation provider into French simulation software leader Dassault. We merged two leading distributors of contact lenses as part of a platform business within New Mountain capital. We sold off the U.S. television business of the Spanish media giant, Prisa, which needed to focus on core domestic and Latin markets. We merged a 3D medical technologies group into one of the top 3D prototyping leaders. In the final analysis, our practice had become, like the overall markets, substantially if not entirely strategic.

I expect the reader of the M&A Advisor's current *Best Practices of the Best Dealmakers* edition will detect a high degree of similar thinking and stories about strategy and synergy underling corporate deal making. That is a reflection of where we are now in the multidisciplinary professions of corporate mergers. That is because in the decade following the greatest financial crisis in eight decades, now we are all strategists.

*Marshall Sonenshine*  
*Chairman, Sonenshine Partners*  
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*A comprehensive M&A strategy is necessary to help dealmakers identify achievable cost and revenue synergies.*

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## **Part I: Front-End M&A Strategy: Development and Execution**

### **A. Strategy: The Foundation of the Deal**

*“The deal is about strategy.”* – Marshall Sonenshine, Chairman, Sonenshine Partners

Sixty percent of M&A transactions fail to achieve their objective. The causes for the failure of these deals are several. Among them are the absence of an M&A strategy, a strategy that is unaligned with corporate strategy or the sacrifice by buyer or seller of an M&A strategy’s discipline and rigor while in hot pursuit of a transaction that may have ceased to be appropriate. Today, with acquisitions often commanding multiples in excess of 10X or 11X, compared to 8X just a couple of years ago, it behooves both buyers and sellers to enter the M&A marketplace with a clear plan. This plan should take into account the changed realities of a supercharged marketplace that, in some respects, would be almost unrecognizable to the dealmakers from a decade earlier, when tandem deal playbooks for corporate and financial dealmakers were the norm, before evolving strategic considerations in an upside-down M&A marketplace induced dealmakers to exchange old playbooks and labels for membership in a single category: *M&A strategist*.

For corporate buyers and sellers, or for the 3,700 private equity firms whose combined impact remains, for now, on the ascendant in an overheating marketplace in which hungry and numerous corporate and private equity buyers scramble to gain the attention of a thinned herd of sellers, a comprehensive M&A strategy is necessary to help dealmakers identify achievable cost and revenue synergies.

M&A, cautions Simon Gisby, Managing Director, Deloitte Corporate Finance LLC, an M&A Advisor 2014 Deal of the Year honoree in the healthcare/life sciences category, does not represent a strategic goal in and of itself. Instead, Gisby says, “It is a tactic upon which to achieve a broader strategic goal.”

The strategic objective can be financial, aimed, for example, at improving earnings per share. It can define a market entry initiative based on the premise that it can be easier and faster to gain market, product or technology access inorganically, via an M&A transaction, rather than building an organic capability internally. Having a clearly defined major strategic objective is important, Gisby emphasizes, “because each goal can result in a different outcome, a different strategy, a different deal process and, for buyers, different targets.” Keeping the overriding strategic objective in mind for quick and easy reference throughout the inevitable twists and turns of the deal process is key. For buyers, this ongoing reference point can help ensure that acquisition targets under consideration meet the strategic criteria. Gisby often reminds buyers of the difference between a candidate and an opportunity. A candidate, Gisby says, is an M&A target that on paper meets all or some of the buyer’s pre-established strategic criteria; An opportunity, on the other hand, is a target that is actionable. Explains Gisby, a buyer may be able to find a target candidate that meets all or some of those criteria. “However, if that target is not prepared to engage in an M&A transaction then the discovery of that target by the buyer does not represent an opportunity.” Gisby asks. On the sell side, Gisby continues, the process is similar, but reversed; the seller wants to identify the buyer’s strategic objective. “Is the buyer seeking to achieve a financial return or scale, or to leverage a seller’s sales force, technology, markets or operations?” As with buyers, an M&A strategy provides the seller with a reality-based reference point during the M&A decision-making process when needed.

Scott Werry, Partner, Partners (a Toronto-based private equity firm that holds its portfolio companies for up to 12 years), provides a PE vantage point. An M&A strategy is especially important in the hotly competitive contemporary private equity marketplace, Werry says. This is “because a well-conceived strategy enables us to proactively identify companies we admire and in which we want to invest – and a well-executed M&A strategy helps us close the deal.”

For Andrew Lohmann, who chairs the M&A practice at Richmond, Virginia law firm Hirschler Fleisher, developing and adhering to an M&A strategy serves a self-protective purpose: “Valuations are so high now that unschooled buyers are vulnerable to overpayment.”

Jeff Cox, Senior Partner, Mercer, leads the Chicago-based Mercer North American Private Equity M&A Group. For buyers, he says, today’s multiples

*Today, without a comprehensive M&A strategy, an acquisition can be a minefield.*

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are so high that without a strategy and considerable discipline around core competency, buyers can encounter some unanticipated difficulty. For example, buyers can extend themselves into unfamiliar geographies that are rife with risk, such as the work councils in Germany, Italy and France. Says Cox, “We are involved in negotiating severance costs in order to shut down a factory in Italy. Those costs are enormous. Due to work council agreements, it is not uncommon for employers to pay a full year’s wages to employees impacted by a plant closing. Multiply that and then take into account all other related costs, such as those associated with defined benefit plans. The price tag is very high.” Today, without a comprehensive M&A strategy, an acquisition can be a minefield, with unprepared buyers experiencing risk that they have never before encountered, and with no reference points as to how to manage it.

## **B. The Components of an M&A Strategy: To Each Its Own**

*“Every client is unique. Every situation is unique.”* - Brenen Hofstadter, President and Supervising Principal, Generational Capital Markets

There are no hard and fast components in a M&A strategy. The components differ according to the needs and aims of each buyer and seller. However, a well-developed M&A strategy offers a reliable roadmap for an organization’s growth and translates a strategic business plan into a list of potential acquisition targets for buyers, or possible acquirers for sellers. The plan should also provide a framework for evaluating potential targets or buyers. The basic plan can consist of the following components:

- Translation of a company’s strategic business plan into a set of drivers and requirements to be addressed by the M&A strategy. Drivers can include current and future markets; market share objectives; required products and needed technologies; current and future geographies; talent requirements; financial objectives; risk appetite and profile; competitor pre-emption assessment.
- For buyers, determination of acquisition financing constraints, including how the acquisition will be funded; the availability of surplus

cash and credit facilities; the value of untapped and new equity as well as debt.

- A clear understanding of possible acquisition or sale pitfalls, including the criteria of the CFO, board of directors, investors and debt holders.
- A list of potential targets or acquirers and their profiles, including appropriate public stock and market research; competitor sections of public company 10K reports; employee recommendations; referrals from investment bankers, attorneys, board members and investors.
- For buyers, preliminary valuation models. For sellers, the desired valuation range.
- Target and acquirer candidates rated and ranked in terms of their impact on the buyer or seller's business and the feasibility of closing a transaction.
- A plan to review the M&A strategy with key stakeholders.

Brenen Hofstadter is President and Supervising Principal of Generational Capital Markets (GMC), a Dallas-based investment banking firm that specializes in representing privately held sellers—often family-owned businesses—mainly in North America. GCM deals typically occupy the \$5 million-\$500 million range. According to Hofstadter, from the seller perspective, especially if the seller is the owner and/or founder of a business, an M&A strategy should be based on seller understanding of the business and the likely buyers and the transaction's timing. In truth, Hofstadter cautions, the seller may have an understanding of one of those three pieces, but not all three. His firm's initial steps, he explains, include helping the seller understand a company's true value, the buyer universe and what the ideal timing of the transaction ought to be. He then asks the seller to compare the company's value, the deal's prospective buyer universe and the deal timing to the seller's personal and business goals to ensure alignment. "Every client is unique. Every situation is unique," Hofstadter says, "but all business owners who are seriously considering the sale of their company should answer the question, 'If the market timing is not a fit with my personal plans and goals, how do I continue to enhance value over time?'" Often, he explains, sellers are cautious about moving into the M&A marketplace. In those instances, investment bankers can help enhance the company's value and salability by maximizing deal flow within the tightest possible time frame via relationships with a wide range of

## DEAL NOTES

### Speaking with...Savio Tung, North America CEO, Investcorp

The M&A Advisor visited recently with Savio Tung in his New York office. In addition to his role as Investcorp North America CEO, Tung is also Investcorp Chief Investment Officer. He is a founder of Investcorp, a provider and manager of alternative investment products, serving high net worth private and institutional clients. Investcorp, with \$10.5 billion in assets under management, is active in five lines of business: corporate investment in North America and Europe; corporate investment in technology; corporate investment in the Middle East and North Africa; real estate investment; and hedge funds. MAA spoke with Tung about several issues, including the purpose and value of an M&A strategy; the relationship of M&A strategy with the auction process; the pros and cons of private equity involvement in M&A transactions; the realization of synergy opportunities and the avoidance of synergy pitfalls; and the importance of an international perspective.

*On M&A strategy:* “Reliance on gut instinct and macho does not work for me. I never proceed without a playbook. My vantage point is that of a middle market private equity investor. We are private equity buyers and sellers. We grow and nurture a company for 5-6 years and then harvest. A roll-up strategy is a key component of our investment thesis as it relates to private equity deals, because by creating synergies in one of our companies, or a strategic fit, or perhaps by strengthening a company’s management team, we are enhancing the value of our investment. The result, for us, is a higher return on our investment.

“Although our middle market companies lack divisions to shed and reinvest capital into their core businesses, we have done many ‘orphan transactions’ in which we buy non-core divisions divested by larger companies. A business judged to be non-core by the parent then becomes a core business under our ownership. In a way, we are doing big corporations a favor by taking one of their divisions and focusing on its growth.”

*On how he competes with strategic buyers during the auction process:* “The truth is that if a strategic buyer has perfect information, that buyer will win most auction processes. In our case, however, we are more efficient. We are more willing to commit to and mobilize a team quickly. We also come across as more management-friendly. These are advantages we think can help us win versus a strategic buyer. However, strategic buyers sometimes have their own constraints because they must be concerned about management social issues, such as staff relocations, which can help neutralize their advantages over us. Sometimes strategic buyers complain that we are too ‘cowboyish’ and that we rush into decision-making. We, on the other hand, can argue that we do not miss the big picture. We, like strategic buyers, have a very good view of the forest, although we might miss a few of the trees.”

*On the pros and cons of private equity involvement in M&A transactions:* “I am a dealmaker, not a middleman. I invest our limited partners’ capital side by side with the management. I do this not for a fee but to earn a return on investment. Having a PE partner in an M&A transaction means that the private equity partner has skin in the game. We tend to be more

focused on management, and frankly, we do a better job in preparing our companies for sale. Although I won't claim that our companies are Sarbanes-Oxley compliant, they have engaged in the right initiatives and governance structures and thus are more ready for an IPO or to thrive as a private enterprise. Those are the pros. The two cons are: 1.) That we are not a long-term investor so are not proficient at making 10-year decisions, and, 2.) That we are not industry specialists. Therefore, we can't take over the operation of a company; we rely on the company's management to do that."

*On promoting synergies early in the sales process:* "If I were the seller I would promote the hell out of the synergies so that I can maximize the price. To the buyer, that represents risk. The margin of error is small. The buyer had better be right about being able to realize the synergy benefits. Any professor or consultant can follow a synergy plan and say, 'Combining these two companies will cut costs, generate revenue and we'll be able to lean on suppliers to obtain a bigger discount.' Those are easy to map out. But implementation and execution are another matter. I've never seen anyone who can execute precisely on a plan and on schedule. Slippage always exists, which is a big disadvantage to buyers."

*On the synergy opportunities he seeks:* "We have two companies. One company is more East Coast-centric. The other is West Coast-centric. When we combine the two companies, the sales forces do not overlap. There are no job losses. Overnight, we have a national footprint. We can tell customers that we can now provide nationwide services. That is synergy."

*On avoiding synergy pitfalls:* "Time and social issues are the two main impediments to synergy realization. Time is the biggest pitfall. We are always late. Everyone is always late. No one wants to be too drastic in pursuit of a schedule for fear of hurting the business. As for social issues, it is easy to map out a new organization chart, but telling each individual on that chart that he or she is staying or going is never a smooth process. I've seen executives below the CEO level balk at executing this phase because they are not accustomed to cutting off colleagues. Often, these conversations are fudged. We think we have exited an employee but instead that former employee returns to us as a consultant. This problem exists for strategic buyers and private equity alike."

*On his international perspective:* "Although we are a middle market private equity business, our perspective has always had an international aspect. The following experience from the company's early years illustrates our continuing international perspective. In 1984, we purchased Tiffany from Avon. Tiffany annual sales were \$4 million, most of which were generated in Japan. But Tiffany management assured us that it could grow the company, and we believed management. Two years later, revenues mushroomed to \$145 million and today they exceed \$1 billion. Does this mean that I am smarter than everyone else? No, it means that back in 1984 other private equity firms were U.S.-focused, wanting to open stores in Phoenix, for example, while we envisioned stores in Hong Kong, Shanghai and Mexico City."

deal brokers that specialize in a seller's industry and geography. Also helpful in this process are the use of Internet business listings, direct mail, direct phone calls, referrals from attorneys, accountants, bankers and other business owners, email campaigns and ads in trade journals.

Phillip Torrence is an attorney specializing in M&A, financial institutions and corporate governance at Honigman, Miller, Schwartz and Cohn, a Kalamazoo, Michigan law firm where he is also the Office Managing Partner. For buyers and sellers in M&A deals, he says, an M&A strategy helps set enterprise goals. "It's vital that buyers and sellers know why they are engaging in an M&A deal and what they hope to accomplish," he says. He recommends a narrowly constructed strategic focus to help ensure a successful transaction. An ill-conceived or more broadly focused M&A strategy, he notes, can result in a phenomenon Torrence regards as more common in M&A than casual observers realize: deal heat. Torrence defines deal heat as "doing a deal for the sake of doing a deal, which is often a recipe for disaster." Chasing and closing a deal, he says, can be a heady and thrilling experience for dealmakers. For buyers, he says, a sound M&A strategy can point the way to a successful target digestion by the buyer. From sellers, whether corporate, a family-owned business or a private equity firm, Torrence, assuming the perspective of a buyer, wants to be informed of seller objectives. He also recommends that sellers, with the aid of a law firm, conduct pre-deal self-diligence in order to make their companies even more attractive to potential buyers. "If it helps a seller obtain the desired sale price, self-diligence is well worth the expense," he declares.

According to Torrence, about 60% of his sell side clients opt for self-diligence. "I help to sell many venture capital-backed companies, which means that we keep our corporate records and virtual data room current. In each venture capital financing, clients nearly replicate acquisition-related diligence." Thanks to this experience, he insists, his venture capital-backed clients are usually well-prepared for their eventual acquisition.

Attorney Andrew Lohmann, whose law firm, was named M&A Advisor "Law Firm of the Year" in 2014, works mainly with entrepreneurial company founders/owners and private equity firms. He advocates identifying divisions of large companies and including them in an M&A strategy as candidates for prospective proprietary M&A transactions. Such transactions, in which a specific buyer is awarded an opportunity to purchase a given division before

*“Heck, no,’ the buyer says, ‘Those people are key employees of the company we’re buying!’” - Andrew Lohmann*

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that division is presented to other buyers by the parent company or by an investment banker, are prized by buyers. Getting that opportunity, however, requires aggressive buyer spadework, including diving deeply into contact networks to explore whether a desirable big-company subsidiary would be right for a carve-out.

The 3-to-7-year non-compete and non-solicit provisions normally included in boilerplate M&A transaction purchase agreements or ancillary documents should perhaps also be re-imagined, Lohmann suggests. “There are opportunities for financial sellers to designate key individuals in the target company for retention as ‘their’ guys and attach a shorter non-solicitation term to such individuals. Traditionally, if a seller desires to be able to hire key employees of the target within a relatively short time after closing, it draws the buyer’s ire. ‘Heck, no,’ the buyer says, ‘Those people are key employees of the company we’re buying!’” A way to resolve that issue early on, Lohmann says, is for the financial seller to include a short list of individuals as carve-outs to the normal non-solicitation term as a component in an M&A strategy. “You don’t get what you don’t ask for,” Lohmann declares.

In addition to identifying synergies, a standard component in most buyer M&A strategies, a framework for conducting due diligence should also be included, Lohmann advises. In the diligence process, strategic buyers tend to drill deeper on fewer issues. These issues, Lohmann points out, “may have burned them in past deals.” Many financial buyers, on the other hand, conduct a broader diligence process, exploring every issue but perhaps not delving as deeply into issues that are more material. What is needed to by today’s strategic, financial and hybrid buyers, Lohmann says, is a more efficient diligence process streamlined for today’s hyper-competitive M&A marketplace.

### **C. Aligning M&A Strategy with Corporate Strategy: Are They a Fit?**

*“Sometimes M&A strategy and corporate strategy fit, and sometimes they don’t—but they should fit.” - Jeff Cox, Senior Partner, North American Private Equity M&A Group, Mercer*



*“If a buyer is doing a deal that will grow the business by 25%, the buyer will be forced by that circumstance to closely analyze the direction of the company.” - Phillip Torrence*

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Establishing an M&A strategy enables buyers and sellers to look through the windshield at the road ahead, rather than in the rear-view mirror at the past. In formulating an M&A strategy company strategists generate forward-looking questions and realistic responses. This exercise aids dealmakers in option evaluation. Usually, however, there are only two available options: accomplishing the stated objective internally and organically, or inorganically, by removing a competitor. A buyer that doesn't yet have a corporate strategy in place needs to construct one if a sizable M&A transaction is planned. Declares Phillip Torrence, “If a buyer is doing a deal that will grow the business by 25%, the buyer will be forced by that circumstance to closely analyze the direction of the company because the buyer will be doing all the modeling and determining the synergies that will enable the company to service its debt or, to the extent that the buyer is using cash off the balance sheet, to justify the returns on the money that is being put to work, as opposed to distributing those funds to shareholders.”

“Sometimes M&A strategy and corporate strategy fit, and sometimes they don't—but they should fit,” Jeff Cox remarks. With top line growth as the chief measure of a company's marketplace value, many companies need to grow, either organically or via acquisition. Companies that opt for an acquisition strategy need to know exactly what they are acquiring and why, counsels Cox. Do they want to expand a global footprint? Are they trying to grow a product line? How will the buyer's and seller's customers be impacted? Many companies are confronted by urgent considerations that demand a convergence of their M&A and corporate strategies. Companies have record cash on their corporate balance sheets and stock buy-backs are failing to supply needed lift. U.S.-domiciled multinationals have troves of cash parked outside the U.S. High U.S. taxes are the price for the repatriation of those cash hoards. Some tech companies are accepting the unknown risk inherent in investing in the emerging markets in which they carry cash on their balance sheets. The fact of the matter, says Cox, “is that M&A strategy and corporate strategy must fit in order for companies to experience any mid- to long-term success.”

*“Every transaction in which I’ve been involved during the past five years has included a buyer who was seeking to meet a specific need through M&A.” - Brenen Hofstadter*

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Investment bankers who represent sellers usually connect with prospective buyers that include M&A as part of their corporate strategy. Brenen Hofstadter is no exception. He analyzes the needs of buyers and sellers and attempts a match. Says Hofstadter, “Every transaction in which I’ve been involved during the past five years has included a buyer that was seeking to meet a specific need through M&A.” For example, he explains, Tarasoft Corp., the Canadian developer of the popular Matrix multiple listing service platform used by 17 North American MLS providers was acquired by CoreLogic, a real estate information and analytics provider, because the buyer desired the Tarasoft MLS technology, plus key managers and employees. Total Safety, a global provider of integrated safety solutions, acquired Pacific Environmental Consulting, a western Canada-based occupational safety and consulting firm, in order to facilitate geographic expansion into western Canada. The recent acquisition of Johnston Grain, Oklahoma’s oldest and largest privately owned grain company, by CGB Enterprises, a U.S. company with Japanese parentage, provided Johnston, the seller, with access to the buyer’s global grain markets.

According to attorney Frank Koranda, Jr., a partner in the Corporate Department at Dentons US, a Kansas City law firm, M&A is usually the growth-through-acquisition component of corporate strategy, but a corporate strategy would also include strategic alliances and human resources initiatives that are unrelated to M&A. Yet, in family offices—law firms that cater to families with a net worth of \$50 million-\$100 million that have recently experienced a wealth creation event like the sale of a family-owned, privately held company—he has witnessed instances in which an M&A strategy can actually directly engender a corporate strategy by efficiently deploying available capital for acquisitions and related investments.

Yet if no overall corporate strategy exists, can the development of an M&A strategy also result in the creation of a corporate strategy? Cox and Koranda believe the answer is yes. Cox has seen instances where traditionally non-acquisitive companies have cut an M&A deal. He cites a recent transaction in which the buyer, with an aging work force “on the back nine” acquired a company that not only provided the acquirer with an expanded product line

but also with vigorous senior managers who eventually proved to be more capable than the buyer's incumbent managers in expanding the buyer's global footprint. According to Koranda, the buyer CEO said, "I don't think we have senior managers that are the best of the best. In Nuco, however, I want the best of the best." Explains Koranda: "We did competency modeling for attributes the CEO wanted for her senior leadership team. We traveled around the world to interview leaders from the buyer and the target." Today, he says, the Nuco executive team consists mainly of managers who transitioned from the target.

Deloitte's Simon Gisby sees a potential danger in creating a corporate strategy based on an M&A strategy because then there is a risk that a company will pursue M&A purely for the sake of pursuing M&A. The result, he cautions, can be a company afflicted with 'dealitis', where transaction pursuit supersedes strategy, thus creating a cycle of poor decision-making.

In short, a corporate strategy is a must in order to prioritize specific short- and long-term company goals and to outline the organization's direction at the board of directors, executive management and ownership levels. M&A, whether it involves a proactive decision not to execute M&A transactions, or to move ahead aggressively, is a crucial aspect of corporate strategy, one that can be revisited and refocused to adapt to changing corporate needs or marketplace realities.

#### **D. How to Avoid Auction Process Pitfalls: Stick to Strategy**

*"It's like a high-wire act at the circus; everything appears to be going smoothly, and then..."* - Phillip Torrence, Leader/Financial Institutions and Corporate Governance Groups, Honigman, Miller, Schwartz & Cohn

The scenario is too familiar to many dealmakers: a transaction begins in the usual fashion, with buyer and seller adhering to their respective strategic playbooks while seeking to obtain optimum terms. The deal moves ahead. Then the jockeying between buyer and seller accelerates as a definitive agreement comes into view. Now the adrenaline spurts and one or both of the parties begins to lose a grip on their strategic moorings. Emotion sometimes trumps logic. Decision-making is impacted. One observer likens this phase to the scene in the movie *Jaws*, when two fishermen imprudently heave a hook baited with a roast beef from a dock at night in an attempt to lure the giant great white shark into shore. The big shark takes the beef-baited hook and aims for open water, pulling the entire dock into the water and taking

dock and thrashing fishermen for a ride for which they had not planned and for which they had failed to prepare. In such instances in the course of an M&A transaction, several unintended consequences can result, none of them beneficial to both parties: the buyer overpays for the target; caught up in the heat of the moment, the buyer is unable to capture the planned deal model synergies. In the worst case, the deal, like the doomed luxury liner Titanic in the 1997 film of the same name, breaks asunder, with buyer and seller taking a bracing ice bath.

Avoiding adrenaline-fueled deal pitfalls is easier said than done, but they can, and have, been avoided. Phil Torrence says that he cautions buyer and seller clients about the precarious nature of the deal execution process. “I advise them that it’s like a high-wire act at the circus; everything appears to go smoothly, and then...” A single misstep or emotion-based misjudgment, when buyer or seller veers from their respective strategic foundations, can topple a carefully constructed deal or result in a transaction that will ultimately prove to be unsuccessful for either, or both, parties. In some cases, says Torrence, the presence of multiple prospective buyers in the phase leading up to the definitive agreement is healthy for buyers and sellers alike. Often, however, in the frenzy of the moment, a buyer push for exclusivity can induce that buyer to grossly overpay. In such situations, Torrence says, “I’m reminded of my college economics professor who often cautioned against impulsive decision-making by using the acronym, TANSTAAFL (There Ain’t No Such Thing as a Free Lunch)”. Occasionally, Torrence says, a buyer bid that far exceeds the others is too good to be true. Sellers, he warns, must be careful when considering exclusivity: “If the seller opts for exclusivity the purchase is retraded several times until it drops below competing bids.” Sellers, of course, can elect to let the exclusivity period run its course and then reenter the marketplace, “But then they are seen as damaged goods,” Torrence remarks. Competitive juices often begin to flow during the diligence process, when emotions can be brought into play. Giving into those competitive urges, says Frank Koranda, must be avoided at all costs. Decision-making should be cool and unemotional. According to Koranda, the only relevant decision for buyers is, “Do you want to buy the asset at a certain price?” Especially for corporate buyers, that decision is very strategic. “So whether the buyer pays a dollar more than anticipated may not have huge implications if the buyer takes a medium- or long-term view of the target’s prospects and potential synergistic fit. Maintaining a disciplined decision-making posture and perspective

*“From start to finish, the auction process is far more abbreviated compared to a year ago.” - Jeff Cox*

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requires an M&A strategy that is closely aligned with corporate strategy.” That perspective, Koranda adds, should be refined well in advance of an auction.

For buyers, remaining true to their investment thesis is one near-surefire way to avoid the dangers of deal heat, dealitis or auction frenzy. Says attorney Andrew Lohmann, “I know of private equity firms that did not make a single acquisition for a year or two because they chose to remain true to their investment thesis.” Nevertheless, he adds, in overheated environments, like the current M&A marketplace, in which private equity firms possess plentiful “dry powder” and are active in raising new funds, it is difficult not to be caught up in the action and perhaps stretching too far in an attempt to do a deal. “There is a fine line between being creative, diving deeply to find synergies to justify a transaction, and trying to justify an acquisition because there needs to be some activity that’s visible to the limited partners,” Lohmann comments. Patience, however, and staying with investment thesis principles, can win the day for buyers and sellers looking to circumvent the potential dangers of auction frenzy.

However, a limited auction is not a potential pitfall to Brenen Hofstadter who represents sellers. In fact, his firm is a proponent of the limited auction concept. He uses that process to sift through buyers in order to find those that are the most serious in terms of their capacity to create the best synergies for his seller clients. Buyers, Hofstadter asserts, seek to try to weigh the value of paying a premium, a perceived premium or a slight premium through the auction process as opposed to a direct deal through a exclusive arrangement. “Some buyers are more effective at that than others, he notes. “Getting the attention of the owners of privately held businesses can be difficult,” he says, “as is creating deal flow for the buyer universe.” Educating and escorting a seller through the pitfalls of the auction process is a necessity, Hofstadter says: “For most owners, one auction process is all they will experience during their lifetimes.”

Today, thanks to the widening imbalance between deal supply and demand, the normal auction process, always an enervating experience for buyers

*“You can never document yourself out of a bad deal.”  
- Simon Gisby*

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and sellers, has become even more intense. Explains Jeff Cox, “From start to finish, the auction process is far more abbreviated compared to a year ago.” Private equity money is time-limited and must be spent. Multiples are skyrocketing: Berkshire Hathaway paid 15X earnings for Chicago’s Portillo’s Restaurant Group in July 2014. Portillo’s is very profitable,” says Cox, “but the expectation is that consumers worldwide will eat hot dogs at the same rate as Chicagoans in order for the buyer to earn a satisfactory ROI.” The tipping point, Cox notes, was the \$2 billion sale of the Los Angeles Dodgers baseball team headed by the Guggenheim Partners hedge fund which, in turn, was backed by insurance company investors. The Dodgers investors, Cox asserts, expect a 4.6% ROI. From his vantage point at Mercer, Cox says that he “sees some of the big players now reaching down into the middle market.” He sees buyers that have traditionally purchased in-country assets only in Canada, for example, now seeking U.S. assets and acquirers that had limited themselves to acquiring North American assets now exploring acquisition opportunities in Central Europe. “It’s all over the board,” Cox declares. Deal demand is high, he adds, “because hedge funds and activist investors are in the face of corporate America, which is sitting on an unprecedented cash hoard with nowhere to spend it.” In addition, private equity funds are obligated to invest time-limited money. Exits and initial public offerings are at all-time highs thanks to sky-high multiples. Stock buybacks are no longer efficient. Therefore, corporations must accept additional risk. Says Cox, “Wall Street is rewarding corporations’ top-line growth, but they can’t grow organically, they have to buy.” The result, for some companies and investors: a level of risk many have not previously experienced.

There is often a tendency for some dealmakers to become so wrapped in the auction process “that they lose their ability to see the woods for the trees,” says Simon Gisby. Decision-making flaws exposed in the throes of emotional responses, he points out, cannot be camouflaged by documentation. “You can never document yourself out of a bad deal,” he emphasizes. Any M&A strategy should have checkpoints placed throughout the process or a framework that enables dealmakers to constantly assess the decision-making process

*“2.0 of this trend will likely find flush social media companies like Facebook and Twitter acquiring big newspaper publishers. The fit is a natural.” - Phillip Torrence*

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to ascertain that the M&A strategic objectives are being achieved. If the objectives become lost in an auction process gone awry, a strategic framework provides the dealmakers with the opportunity to either modify the deal or walk away from it. A buyer or seller declaration that, “I’ve got to close this deal at all costs” could be a recipe for an M&A failure, says Gisby.

### **E. Using an M&A Strategy to Identify Non-Core Investment Disposal and Spin-Offs**

*“There are probably portfolios within an acquired company that need to be scrutinized because they are not core to the buyer’s business.” - Cathy Skala, Vice President/Integration, Baxter International, Inc.*

The M&A landscape is rife with evidence that failures of synergy are compelling enterprises to shed businesses that once were a tight fit with corporate strategy but now are not. Corporate and M&A strategies in industry clusters such as media and broadcast, for example, now call for the rending of internal strategic ties that have been in place for generations. Chicago’s Tribune Company has spun off the print version of the venerable *Chicago Tribune*. Time Warner has spun off all of its iconic print stalwarts, including *Fortune*, *Money*, *Sports Illustrated* and *Time Magazine* itself. E.W. Scripps and Journal Communications, publishers of the *Milwaukee Sentinel* newspaper and other print properties, announced in mid-summer 2014 that they planned to merge and then spin-off their combined slower-growing newspapers, leaving the merged entity focused on broadcast television. The transaction will create two publicly traded companies. One, which would retain the E.W. Scripps corporate moniker, would be one of the largest owners of ABC-affiliated TV stations, with a presence in eight states, including Florida, Texas, Colorado, Missouri and Ohio. The other corporate entity, dubbed the Journal Media Group, will own newspapers in 14 markets and is expected to generate more than \$800 million in annual revenues. Gannett, the owner of the national newspaper, *USA Today*, will also split its print and non-print businesses, spinning off its print properties, including *USA Today*, into a separate publicly traded company. This trend, says Phillip Torrence, has been incubating for

the past two decades as once-lush print businesses were steadily outflanked by digital media. “2.0 of this trend,” Torrence says, “will likely find flush social media companies like Facebook and Twitter acquiring big newspaper publishers. The fit is a natural.” Other industries, including healthcare, are undergoing a similar transition.

Adhering to an M&A strategy has resulted in subsidiary spin-offs at other large corporations, such as Tyco and Johnson & Johnson. Procter & Gamble, traditionally among the Midwest’s highest profile corporations, has yet to set a definitive course regarding M&A, Jeff Cox notes: “P&G invited a hedge fund to analyze its corporate structure; the hedge fund recommended that the entire company be broken up.” Procter & Gamble senior management determined that it aspired to achieve a number one or one-and-a-half ranking in every market category in which the company was to remain active. “P&G looked at the categories in which the company was ranked third or fourth and decided that buying its way to the top ranking did not make sense,” Cox says. In those categories – with one exception in which P&G decided it could buy the top ranking – an exit strategy was deemed appropriate. As companies sort through acquisition opportunities in search of those that are most appropriate according to their M&A strategy, most will likely conduct an exhaustive review to learn which target will bring them the most substantial ROI.

All companies, large and middle market, can benefit from employing their M&A strategy to identify parts of their businesses that are candidates for divestiture because those assets are not aligned with M&A or corporate strategy. Acquisition targets can be scrutinized in the same fashion, according to Cathy Skala, Vice President/Integration at Baxter International, Inc., a Chicago-area healthcare company that focuses on products to treat hemophilia, kidney disease, immune disorders and other chronic and acute medical conditions. “There are probably portfolios within any given acquisition that need to be scrutinized because they are not core to the buyer’s business,” she says. “It’s important that the targets housing those units not be screened out, but the eventual buyer should be purposeful in ensuring that non-core business units of groups are spun off as soon as practicable in order for the acquirer to remain true to its core and to its corporate strategy.”

An M&A strategy can certainly apply to the buy side of a transaction, says Scott Werry, if the buyer is aiming to grow a business via M&A. He recommends that buyers continually refine, reshape and refocus their businesses around



*Multiples have risen steadily, and PE firms continue to slowly but steadily acclimatize to steeper purchase prices.*

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core priorities. Simon Gisby counsels that an M&A strategy should not focus purely on external M&A but also on internal M&A in the form of portfolio realignment. For example, he says, if the goal of M&A is financially driven, a question should be asked. Can the financial objective be achieved via a company's existing portfolio of products, services, geographies or businesses rather than seeking M&A opportunities? "The M&A lens should be focused internally and externally," Gisby says.

## **II: Private Equity Involvement in M&A: Pros and Cons**

### **A. Private Equity's Evolving Role: What's Old Is New Again**

*"Private equity is beginning to again outpace and outpay strategics."* - Phillip Torrence, Leader, Financial Institutions and Corporate Governance Groups, Honigman, Miller, Schwartz & Cohn

Just a few years ago, private equity firms ruled the M&A roost: deals were plentiful as were eager limited partners. Then came the global recession. Fast forward to 2014 and a slowly recovering economy. Deals are not yet as plentiful as they once were. Those that exist attract a long list of buyer candidates, many of which are well-heeled corporate strategics. Although they compete aggressively with strategics for deals, many private equity firms only rarely find themselves in the buyer winner's circle. The reason: strategics, for the moment, are often all too willing and able to wildly outspend their private equity competitors in pursuit of a valued target. Yet there are strong signs that private equity firms are beginning to rebalance the competitive deal environment in their favor. Declares attorney Phillip Torrence, "Private equity is beginning to again outpace strategics." Prior to 2008, Torrence recalls, "Strategics would put their checkbooks away when private equity entered the auction process, because private equity firms were usually willing to pay so much more." After the recession hit, however, private equity firms, thanks to banks' borrowing limitations, lost the leverage that had produced such attractive returns to investors. Beginning in 2012, however, the pendulum began to swing in favor of private equity. Although strategics continue to hold sway in an overheated deal environment, private equity is back in the hunt.

*PE firms are active managers of their portfolio companies, finding ways to maximize value.*

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Nevertheless, PE firms continue to hang back as buyers, kept at bay as the lure of strong equity markets convinces funds seeking to exit assets to opt for a public share sale or to turn to cash-laden corporate buyers. Most PE firms, however, are wrestling with asset price inflation as valuations, fueled in part by asset scarcity, the swing to IPOs as well as a growing volume of undeployed fund capital leaves PE firms paying out more as they seek ways to spend cash. Multiples have risen steeply and PE firms continue to slowly but steadily acclimatize to steeper purchase prices.

## **B. The Pros**

*“Private equity firms can be relied on to provide a floor on valuation and to skillfully execute a transaction.”* - Scott Werry, Partner, Altas Partners

Astute financial buyers with management and operating capabilities, private equity firms mostly share a common business model: They buy, develop and subsequently sell businesses. They acquire operating companies for their fund's portfolio by making direct equity investments into those portfolio companies in exchange for a percentage of ownership. Most PE targets have already matured beyond the proof-of-concept phase, with targets possessing a definable market position, a solid revenue base, sustainable cash flow and a competitive advantage plus the opportunity for further growth and expansion. PE buyers expect to profit from the cash flow thrown off by the operating company and from capital gains on exit. Most PE firms share an incubation period of five to seven years for each portfolio company before the company's sale. The exit provides a private equity firm with liquidity that can then be used to invest in another portfolio company or to distribute as proceeds to the firm's limited partners.

On the plus side, PE firms can provide portfolio companies with large funding infusions often measured in hundreds of millions to billions of dollars. In numerous instances, these funding infusions can spur portfolio company growth, thereby igniting hiring. PE firms are active managers of their portfolio companies, finding ways to maximize value. Many PE firms prefer to retain

portfolio company senior executives in whom they have confidence and then provide them with the means to grow the company and prepare it for sale. The combination of bountiful funding, expertise and various incentives can bring positive results for investors in PE funds and for retained portfolio company managers. In fact, a 2012 Boston Consulting Group survey found that more than two-thirds of PE transactions resulted in at least a 20% growth in portfolio company profits, and about half the deals generated portfolio company profit growth of at least 50%.

“PE firms can be relied on to provide a floor for valuation and to execute a transaction,” Scott Werry points out. These two benefits, he adds, provide sellers with a price to compare with other alternatives, such as an IPO or a sale to a corporate buyer. For corporate buyers, he says, there can be a benefit to partnering with a private equity firm. PE firms, Werry says, are able to bring execution capabilities to the transaction process, especially during the due diligence phase. “PE firms can work with a corporate buyer throughout the deal process, capitalizing on their efficient execution to close a deal.”

Attorney Frank Koranda works with middle market buyers and sellers and is familiar with the transactional skill of PE firms in an M&A deal. PE firms, he insists, can react more rapidly to opportunities than strategics that are often burdened by sizable bureaucracies. For sellers, he adds, the number of PE firms and the diversity of the PE universe often represent more options for sellers. “Sellers can parse that PE universe to find the firm with most appropriate experience in the seller’s space,” he says. For buyers, says Andrew Lohmann, involvement with a PE firm means access to capital. For lower middle market sellers hoping to retain their senior managers after an acquisition, there are PE firms that take a non-control approach or assume a position as a mezzanine lender. Another advantage for sellers in using a PE firm, according to Simon Gisby, is that PE firms adhere to the seller’s timetable as well as provide competitive tension throughout the sale process. For strategic buyers, Lohmann says, the major attraction of PE firms is their ability to respond to “big deadlines.” Brenen Hofstadter, in representing lower middle market and middle market sellers almost exclusively, likes to include private equity firms on the roster of prospective buyers. He prefers PE firms that have holdings in his clients’ marketplace space. “There are thousands of PE firms operating in North America and we have access to many of them through our databases and our relationships, but we focus on the top 50 that operate in our client’s space.” Hofstadter says.

*“When a private equity firm enters the picture, there is a new sheriff in town.” - Frank Koranda*

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In the current overheated and often overpriced deal environment, there is an emerging way for strategics and PE firms to collaborate for the benefit of both. When a large multinational decides to shed subsidiaries, prospective middle market strategic buyers that want just a slice of the subsidiary to complement their business often find themselves trampled by a stampede of big strategics willing and able to swallow the entire sub. According to Jeff Cox, this scenario represents a perfect moment for PE firms to partner with some of the wealthier middle market buyers on non-core assets that the strategic does not wish to buy in their entirety. The middle market buyer can buy the entire subsidiary, scoop out the slice of the business it wants and private equity can take the remainder. Explains Cox, “This will enable the middle market buyer with a healthy balance sheet to be successful in a bid without assuming excessive risk.” As an example, he cites a cross-border deal in which he was involved. His client was a U.S. beverage company that wanted the beverage division of a food company in a former Communist-bloc country. Although his client might have partnered with a PE firm to strike a deal, it chose not to do so. Nevertheless, the model is valid, Cox insists. The objective for a middle market strategic, he says, “is to find a PE buyer with a similar culture that possesses the necessary discipline and rigor and is prepared to make the needed investments.” With plentiful funding available for strong deals, PE firms like Toronto’s Altas Partners choose to access deal financing after a transaction is arranged rather than raising a fund. Jeff Cox calls this concept “another very intriguing investment model.”

Some sellers opt for exclusive arrangements with private equity firms to achieve marketplace leverage by not exposing their sale strategy to competitors. The information will eventually reach the marketplace, even with non-disclosure agreements, says, Phillip Torrence, but using exclusivity with a PE firm to prolong secrecy has been proven to be an effective tactic. For buyers, Torrence adds, teaming with a private equity firm provides a link to the deep knowledge base possessed by some PE firms.

## DEAL NOTES

### **Planning for Synergy Realization: Do It Early**

Developing a formula for calculating synergy realization is a must-do post-close task. Failure to undertake these calculations is likely to have a disastrous impact on the chances for a transaction's long-term success. Simon Gisby, Managing Director, Deloitte Corporate Finance LLC, puts it clearly: establish a day-one readiness plan post-close. "At some point between the LOI and the close, maybe even pre-LOI, best practice is for the buyer to begin mapping out post-close integration in the classic day 1-100 timeframe." Depending on the nature of the transaction and how the deal is negotiated, it may be possible for the synergy realization mapping to start pre-close with the collaboration of the seller. Gisby advises: "Buyers should never place themselves in a position where they are closing a deal minus any plan to realize anticipated synergies." Sellers, he adds, are caught in a balancing act: though there is a need to collaborate with buyers in an early forward planning effort, they have to balance that need against the possibility that the planning process may disrupt their business, or that the deal may not be consummated. In any case, Gisby emphasizes, the early formulation of a plan to realize synergies is a necessity for both parties in the transaction.

Cathy Skala, Vice President/Integration, Baxter International, Inc., advocates a close examination of the target's finances and cost structure. Such an examination, based on benchmarks, should enable the buyer to gain an understanding of the cost of the target's goods sold, the rough general and administrative expense and R&D. Buyers, she advises, "should look at the percentages and compare them to their own costs in those areas. "If the buyer sees marked disparities from typically expected costs, that is a red flag."

For attorney Phillip Torrence, Office Managing Partner at Kalamazoo, Michigan law firm Honigman, Miller, Schwartz & Cohn, red flags in the synergy planning process have a human face. These individuals, he says, exist in every organization and either resist the planning process or prefer to favor assumptions rather than calculations. He says he cautions his clients with this advice: "You can't do a good deal with a bad guy." However, buyer/seller collaboration represents a bright green light for Torrence. The most fruitful scenario, he says, is one in which buyer and seller management team members do discuss their current businesses but "engage real-time in collaboration about the direction of their industry."

Jeff Cox, Senior Partner, North American Private Equity M&A Group, Mercer, is faced with the task of effecting timely resolution of synergy-related HR issues covering myriad categories, including change control and retention agreements, severance and enhanced severance and the transfer of assets related to assuming control over defined benefit or 401(k) plans. Then there is the potentially thorny calculation of reserves available for active medical claims. "If we anticipate inheriting an ongoing real-time liability, that liability must be estimated on a go-forward basis to protect the buyer. It's a challenge."

*Loss of decision-making control can impact the exit strategy for a PE portfolio company.*

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### C. The Cons

*“When a private equity firm enters the picture, there is a new sheriff in town.”*

- Frank Koranda, Jr., Partner, Corporate Department, Dentons US.

For some sellers, the dilution of their ownership position, thanks to a relationship with a PE firm, may prove to be a negative. Association with a private equity group provides buyers with plentiful funding but can also, in some cases, result in the loss of control of basic elements of business operation, such as strategy formulation, employee hiring and dismissal and management team selection. Other acquisition financing options can also involve relinquishing of seller control, but because a PE firm’s stake in a target is usually higher than a strategic’s, the chance for seller loss of control is sometimes greater. Loss of decision-making control can impact the exit strategy for a PE portfolio company, which may involve an outright sale that might not have been the chosen strategy of the portfolio company’s management team. As financial buyers whose prime objective is to enhance the value of a portfolio company for sale purposes to maximize sale profits, the perspective of private equity firms can sometimes conflict with the approach of target company owner/managers who may possess a broader outlook and who, in some instances, may place a higher premium on employee and customer relationships and corporate reputational issues than a PE owner might. Post-close job security is often a concern for a target’s key managers. “Some are happy to ride off into the sunset,” says Andrew Lohmann, but most want to stay on and perhaps obtain stock options or synthetic equity, thus getting a second bite of the apple five years down the road.” Another potential negative associated with private equity involvement in M&A deals is that fewer cost and revenue synergies may exist than were hoped for by the seller. “Maybe there is less likelihood of achieving an optimal purchase price from a private equity buyer than from a quasi-strategic buyer with a financial objective but a synergistic platform,” remarks Lohmann.

In addition to a lower-than-anticipated valuation, a potential cultural change can represent a private equity negative to some sellers. Frank Koranda’s law

frequently works with middle market sellers. Koranda says, “What I often see is that when a PE firm enters, there is a new sheriff in town.” PE firms can impose new metrics and deliverables on sellers. When considering the impact of a private equity buyer on their organization, members of a seller senior management team, says Koranda, ought to be aware that when the transaction closes the PE buyer may also impose a cultural change on the acquired company. The question of whether senior managers will be comfortable with such a change needs to be resolved by those managers who decide to remain with the post-acquisition company.

## **Part III: Synergy Identification and Calculation: the End of the Beginning**

### **A. Including Synergy Opportunities in an M&A Strategy:**

*“It all depends on the deal and why the deal is being done.”* - Cathy Skala, Vice President/Integration, Baxter International, Inc.

When buyers pay for synergies in M&A transactions that are based on goals set for in their M&A strategies, they are paying for synergy opportunities, not for the certainty that those opportunities can be realized, which is a separate challenge for buyers. Many deals feature significant opportunities for creating incremental cash flows from cost reductions and gains in revenue. In most deals, buyers succeed in gleaning synergistic value from low-hanging fruit—job redundancies and consolidation of real estate, for example—but some buyers are not as effective at identifying, valuing and capturing synergies that are less defined, such as revenue-related synergies or synergies gained from skills transfers. Revenue synergies can prove to be especially difficult to value and capture and are frequently overvalued. Some dealmakers suggest that revenue synergies should not be included in the deal valuation process. Some insist that such synergies are non-existent, although most dealmakers consider revenue to be a source of real value. In any case, the match of M&A strategy to synergy realization is sometimes based on assumptions and calculations that may not play out as anticipated in the long run. The key is to use M&A strategy as a framework for synergy identification and appraisal, and to proceed cautiously in identifying and calculating synergies that are likely to be real and lasting, culling out those that are likely to be aspirational only.

*“Seller finance and accounting systems represent the first changes a strategic buyer makes post-close.” - Brenen Hofstadter*

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Private equity firms that are creating M&A strategies are likely to find synergies in a target's finance department, back office IT support and perhaps a geographic overlap in sales teams, depending on the target's existing platform, according to Frank Koranda PE-acquired companies that are not roll-ups, however, may lack a roll-up's support platform and thus will require assistance from the PE sponsor to build one; in most cases, a platform will need to be built organically. In strategic deals, however, he adds, synergies may be quickly achieved because the buyer platform already exists. On the revenue side, PE firm executive Scott Werry says his M&A strategy seeks ways to cross-sell products or services to new customers and channels. On the cost side, he explains, his M&A strategy plots synergies to be gained although he admits this strategy is difficult to execute from the production of goods and services as well as synergies associated with corporate expenditures that include selling, general and administrative expenses (SG&A) and ways to purchase items in bulk to achieve procurement savings, as well as by resolving redundancies in employment, services and manufacturing. Seller rep Brenen Hofstadter looks to buyers from the seller's industry to provide new customer markets, or specific products and services that complement the seller's offerings. Echoing Frank Koranda, Hofstadter looks to buyers to also provide finance and accounting systems that are sophisticated than his client's. In fact, he adds, “Seller finance and accounting systems represent that first changes a strategic buyer makes post-close.” In addition, he continues, his M&A strategy calls for a prospective buyer to also bring a sophisticated board of directors, and the capability to execute add-on acquisitions, both of which my client usually lacks.

Synergy realization hinges on the M&A strategy, declares Cathy Skala. “It all depends on the deal why the deal is being done.” In deals that are focused on achieving revenue synergies, for example, the emphasis is on developing, cross-referral and cross-sell capabilities and/or entering new geographies. In deals focused on revenue synergies, Skala explains, cost synergies are secondary: “They are there but they are not the main focus of the deal.” However, other transactions are more focused on cost synergies, “because



the buyer is not only expanding its portfolio but also seeking to capture more margin,” Skala says. Cost synergies are then found in eliminating redundancies associated with back-office functions. In the revenue-focused deals consummated by her company, Baxter International, achieving supply chain synergies has been a primary driver, as have purchasing synergies on the cost side, adds Skala.

Talent acquisition synergies have been the chief strategic objective in the deals in which Phillip Torrence has been a participant. Many dealmakers concentrate on the so-called “hard” revenue and cost synergies, Torrence points out, but it is the top-third level of vice presidents who have a deep understanding of a business that his clients seek to ‘lock up’ in the transaction. “They’re the ones I like my teams to focus on first, before they address the hard assets.” Torrence also uses the deal process to have his team members in-depth interview with key target managers.

Simon Gisby takes the more traditional route, favoring growth-oriented revenue synergies that facilitate the following: penetration of new markets; cross-selling; leveraging special property and technology to create new customers and enter new geographies; and leveraging operating costs in manufacturing, supply chain, distribution and IT; leveraging alternative access to capital, including less expensive capital; and leveraging vendor costs. Sellers, he says, should look down their entire P&L, line by line, to pinpoint synergistic opportunities. The reason for such a seller review, Gisby says, “is that this is the exact analysis that the buyer is conducting.” All of this, he points out, connects with the objectives set forth in the buyer’s M&A strategy and with the need for that strategy. Does the target enable the buyer to meet the M&A strategy’s revenue-related objectives? Is the acquirer able to generate increased revenues from the same cost base or from a lower cost base? On the balance sheet, Gisby says, the issues usually hinge on capital costs and the likelihood that working capital can be improved.

Human resources-related synergies are Jeff Cox’s specialty, “because the synergy opportunities in that space are huge,” he declares. He seeks answers to the following questions: What is the buyer or seller’s risk tolerance? Which seller best practices, observed by the buyer during diligence, match up with the buyer? “We look at anything and everything around HR-related practices, such as employee awards, how the seller drives employee behaviors, communications policies, infrastructure configuration, training and development, talent management and succession training,” Cox states.

*“If sellers are promoting potential synergies, why didn’t the sellers achieve those synergies on their own?” - Jeff Cox*

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## **B. Early Promotion of Potential Synergies: What Are the Disadvantages for Buyers?**

*“Know your audience.”* - Frank Koranda, Partner, Corporate Department, Dentons US.

Synergy promotion by buyers and sellers can be a slippery slope for both. There are clear advantages for each if their promotion tactics succeed, but also dangers in that a buyer may pay too much for too little and a seller may sell too much for too little.

When it comes to early promotion of synergies by buyers, is modesty, or honesty, the best policy? According to Andrew Lohmann, buyer restraint is usually advisable: “A buyer touting synergies, and how the enterprise will be bolstered by acquisitions, can seem threatening to sellers who may hear in that expressed vision the strong hint of consolidation and the possible elimination of certain positions, including those of the seller CEO and members of the seller management team.” Another possible pitfall for sellers when a potential buyer extols synergy: the occasional tendency of some seller investment bankers to try to capitalize on buyer optimism by exaggerating the potential synergies to convince the buyer to increase the purchase price beyond that cited in the initial indication of interest. The unintended result for sellers: the buyer then downplays the potential synergies in order to lower the price. On the flip-side, buyers may gain an advantage because early synergy touting captures seller interest and may differentiate the buyer from the competition.

Over-eager sellers are also capable of touting potential synergies. “Every seller number I see is pro forma-adjusted, which begs the question, if sellers are promoting potential synergies, why didn’t the sellers achieve those synergies on their own?” says Jeff Cox. The disadvantage for the buyer who takes the seller’s synergy bait and opts for the acquisition: is that the potential synergies may ultimately prove to be little more than smoke and mirrors. A fail-safe solution: It is incumbent upon the buyer and seller to do their own diligence. The advantage for the seller in promoting potential synergies is that such promotion demonstrates and illustrates the value creation the transaction will

have for a buyer and, by doing so, position the seller to negotiate some of that value creation. According to Simon Gisby, “The intrinsic value of the target as a stand-alone, by definition, should be less than the intrinsic value of that business for the buyer.” The difference between the two is the value creation the buyer expects to garner from the acquisition, which is the ROI of the transaction. For the seller, the art of the deal is to capture, in the sale price, much of that intrinsic value. One way for the seller to achieve that objective is to illustrate for the buyer the synergies the buyer will likely obtain from the deal, therefore implying to the buyer that the seller is unwilling to sell for the company’s stand-alone intrinsic value but expects to share in the benefit the buyer will derive from the transaction. For sellers, explains Gisby, “this often means engaging in a different synergy analysis for each potential buyer.” The buyer, however, does not appreciate being sent an analysis by the seller, Gisby cautions. Instead, the buyer prefers to create its own synergy analysis and, to the extent possible, keep the results of that analysis proprietary so that the seller remains unaware of the potential value creation the buyer anticipates to derive from the deal. The buyer will always prefer to pay the stand-alone value of the target, while the seller wants to be paid as much as possible of the intrinsic value the buyer expects. “The art,” declares Gisby, “is in how the difference is split.”

To Cathy Skala, this art form represents a tricky balance for both buyers and sellers. The seller obviously desires a sale, she says, but may be promoting synergies based on the seller’s parochial perception, whereas the buyer’s perception of those synergies may differ according to how the buyer is organized and structured. “If the buyer is not well-educated in how to assess a deal, the buyer is susceptible to being oversold by the seller on potential synergies, synergies that cannot be realized because those touted by the seller fail to align with the buyer’s organization,” she says. To Skala, the buyer should take its own realistic assessment of potential synergies, consider the seller’s assessment, but not accept the seller assessment as gospel.

Brenen Hofstadter coaches his seller clients to promote synergies by offering memos during buyer visits to pique buyer interest and hopefully to maximize value. Yet he also counsels sellers to avoid over-promising. Business owners tend toward optimism regarding synergies and the potential of the business they have built, especially should their business become aligned with a larger corporate entity, Hofstadter points out. However, he adds, “The most astute

*“We worry about making assumptions that synergies will be achieved sooner than reality tells us they will.” - Scott Werry*

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buyers I’ve worked with during 100-plus M&A transactions are those that bring other aspects to the table in addition to money.” For example, a buyer from the seller’s industry will bring new customer markets, a product or service that might dovetail with the seller’s offerings, plus financial and accounting systems that are more sophisticated and efficient than the seller’s. Sellers can indeed oversell synergies, Frank Koranda says, a tactic that may cost sellers dearly in the near future. Rather than emphasizing pricing,” says Koranda, it is better to identify the areas in the seller company that might fit comfortably into buyer organizations. His advice: “Know your audience; customize the presentation to fit that audience.”

### **C. Avoiding Synergy-Related Pitfalls: Early Identification Is Vital**

*“You have to give yourself truth serum when you ask yourself, can I really do this in the designated time period?” - Simon Gisby, Managing Director, Deloitte Corporate Finance*

It often seems that there are as many synergy pitfalls and the ways to avoid them as there are dealmakers. What there is, though, are two universally accepted words of advice regarding synergy realization pitfalls: early identification. Employing those words of advice, however, can be trying in the days following a deal closing. Fatigue hangs heavy, flavored by the dregs of a fast-fading adrenaline rush. A breather is needed by all the deal participants. But this is no time for a breather. Deal decompression is but a cruel mirage. Deal fatigue, to Frank Koranda, looms as the major impediment to early identification of synergy-related pitfalls. “Renewed energy is needed as soon as the closing ink dries, but there is precious little immediately available to negotiate the challenges of the ensuing 100 days, the usual time frame for dealmakers to claim a captive audience. Employees are ready. They may never be more attentive. They are open to change and malleable. According to Koranda, the most effective way for dealmakers to cope with deal fatigue while still moving forward to synergy realization is for a transition team to begin working and planning in earnest to cope with potential pitfalls while the deal negotiators are wrapping up the close. That way, he says, a core group of executives is pushing toward the goal while others catch their breath.

Executing an integration plan is always an arduous undertaking, admits Scott Werry. “We worry about making assumptions that synergies will be achieved sooner than reality tells us they will, because they always take time to execute.” The other pitfall, according to Werry, are the ramifications of today’s condensed due diligence time frame. The major ramification, he notes, is the inclination to overestimate the potential of synergies, an overestimate usually based on a buyer’s brief interchange with its target company counterparts. Avoiding that potential pitfall, he says, can depend upon the early inclusion of expertise in the target’s industry to set reliable and realistic benchmarks based on past experience. From a seller investment banker’s perspective, Brenen Hofstadter acknowledges a synergy realization process that can range from six to 18 months, a wide range that can encompass numerous potential pitfalls. He recommends that bankers maintain a close relationship with the companies’ existing management and the management that came with the transaction. “There is a strong correlation between the performance of the combined business short-term and the relationship between the parties,” he says.

For Cathy Skala, synergy pitfalls can hide in the parameters to which the parties must adhere in the definitive agreement phase. The devil, she asserts, is often in the data. “Determine what data is sharable, maintain an orderly data room and obtain a clear understanding of the opportunities for synergy realization,” she advises. The most significant pitfall, she says, is delaying the opportunity to gain synergies as soon as the deal is closed. The solution: have plans in place to implement those synergies on the revenue and cost side. Those plans must be communicated to all parties, she counsels, especially plans regarding the implementation of cost synergies that may impact employees’ jobs and lives. “The sooner the buyer can act on this, the sooner that management can definitively communicate with employees about plans and objectives and the timing of their implementation, the more successful the post-close will be in terms of synergy realization,” Skala remarks.

Simon Gisby agrees. There is usually an overestimation of the synergies and an under-appreciation of the time and cost required to achieve a given synergy. “You have to give yourself truth serum when you ask yourself, can I really do this in the designated time period?” he says. To expedite the process on the acquirer side, Gisby recommends, that buy-in from critical stakeholders possessing the experience and responsibility be obtained and their participation agreed to as early as possible post-close in order to help

ensure timely synergy realization. On the sell-side of the transaction, he adds, the risk of synergy identification is one of credibility, which leads, he says, to the issue of managing expectations, “because the seller desires to engage the buyer in discussion yet the buyer will only engage in discussion if the buyer is convinced that seller expectations are realistic.” He has witnessed private equity firms asking during the auction process, “Does the seller have realistic expectations of value, because if the seller’s expectations are unrealistic, what is the point of expending the time and effort necessary for the buyer to get up to speed on the industry and the opportunity?” Gisby’s advice to sellers is in the form of another question: Are you sending a credible message to the buyer universe around value expectations?” Declares Philip Torrence, “Successfully avoiding synergy-related pitfalls involves a diligence process that requires the participants to turn over the rocks and look under them. It is more than just a legal, accounting or business due diligence; it is synergy due diligence, which is a completely different animal, due to the soft factors.”

Underestimating customer response to an acquisition, according to Andrew Lohmann, is one of those soft factors and is, in his opinion, one of the most dangerous synergy-related pitfalls. “It is easy to put on paper that a customer that buys from the acquirer and the target will react positively to an acquisition, but reality is not always on paper.” A customer has a need to diversity its vendors. Simply combining a buyer and a target may not necessarily result in the anticipated dollar-for-dollar synergy. Lohmann advises conducting a customer channel analysis. Consider, he says, a case in which a platform company conducts its business through a distributor network. If that company is considering acquiring a target that maintains a different channel in which the target directly serves its customers, are synergies possible? “The target is now selling a product directly,” Lohmann says, adding, “Does that hurt the feelings of the distributors the buyer has worked hard to please? I believe that there is much value to the financial and strategic buyers that have their fingers firmly on the pulse of the emotions and personalities that are inevitably involved in the typical middle market M&A transaction.”

## **Conclusion**

M&A strategy and the quest for synergy realization are married; tied inextricably to the success of any acquisition, from high-profile mergers to lower-profile, but equally intense, middle market acquisitions. History has proven, time and again, that any attempt to shortchange either strategy formulation and implementation or the measured quest for post-close synergy realization will adversely impact the other and will add yet another company name to the growing list of deal casualties that continue, rightly, to spook and chasten M&A dealmakers worldwide.

## CONTRIBUTORS' BIOGRAPHIES

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