Managing the Risks in Corporate Acquisitions
April 2014

Howard E. Johnson
MBA, FCPA, FCA, FCMA, CBV, CPA, CFA, ASA, CF, C.DIR

VERACAP M&A INTERNATIONAL

About Veracap M&A International

Veracap M&A International Inc. is a leading investment bank advising on acquisitions, divestitures, financing and shareholder value initiatives.

As a member of M&A International, Veracap forms part of the world's leading affiliation of M&A advisors, with over 600 professionals in 41 countries.

Veracap is a sister company of Campbell Valuation Partners, Canada's longest established independent business valuation firm.

www. veracap.com

Speaker

Howard E. Johnson

MBA, FCPA, FCA, FCMA, CBV, CPA, CFA, ASA, C.Dir

Managing Director, Veracap M&A International Inc.

(416) 597-4500; hjohnson@veracap.com

Howard is a Managing Director of Veracap M&A International and its sister firm, Campbell Valuation Partners Limited. Howard has been involved in business valuation, acquisition, divestiture, and shareholder value advisory assignments for corporations throughout North America. He is the author of several books on the subjects of business valuation and corporate finance, and has acted as an expert witness on valuation matters before the courts.

Disclaimer

This material is for educational purposes only. It deals with technical matters which have broad application and may not be applicable to a particular set of circumstances and facts. As well, the course material and references contained therein reflect laws and practices which are subject to change. For these reasons, the course material should not be relied upon as a substitute for specialized advice in connection with any particular matter.

Although the course material has been carefully prepared, the author does not accept any legal responsibility for its contents or for any consequences arising from its use.

Overview of the Acquisition Process

1. Pre-acquisition Planning
2. Search for targets
3. Initial assessment
4. Valuation
5. Negotiate the LOI
6. Due diligence
7. Purchase agreement & closing
8. Integration

Pre-acquisition Planning

- Fit with strategic plan
- Build vs. buy
- Policies and procedures in place
- Resource assessment
  - People and money

Search for Targets

- Search criteria
- Active vs. passive search
- NDA's
- Dealing with auctions

Initial Assessment

- Confidential information memorandum
- Publicly available data
- Data room
- Management presentations
- Assessment of other potential bidders
  - Corporate acquirers and PE firms

Initial Assessment

- Strategic fit
- Likelihood of integration
- Product and service offerings
  - Sustainable competitive advantage?
- Revenue base
  - Stickiness and concentration
- Management and employees
- Financial performance
  - Historic and prospective
- Synergies

Transition Risks

- Loss of customers
- Non-transferability of key contracts
- Loss of key employees
- Change in culture
- Additional costs / lost revenue during integration
- Damage to brand names and other intangibles acquired

Valuation

- Multiple of EBITDA
  - Beware the limitations
- Discounted cash flow
  - Capex / working capital considerations
- Synergies
- One-time costs
- Balance sheet requirements
- Intangible value assessment
- Public market comps & industry transactions
- Impact on pro-forma results

M&A Valuation Dynamics

Buyers

Detailed Calculations

1. Discounted cash flow
2. Comparable transactions

Sellers

Preliminary Calculations

1. Comparable transactions
2. Discounted cash flow

Dynamic

Investment value

Market influences

Negotiations

Synergies

- A premium over ‘stand-alone’ value due to:
  - increase in free cash flows due to higher revenues or reduced costs
  - reduced risk in achieving free cash flows
  - additional growth opportunities and ‘strategic value’
- Should be separately assessed
- Unique to every acquirer
- Buyer is in a better position to quantify
- Apply probability factor to reflect risk
- Synergies not paid for act as buffer
- Can be a key negotiating point

Financing

- Seller promissory note
- Senior debt
  - Currently 3x EBITDA +
  - Security considerations
  - Covenants
- Subordinated debt
  - All in cost around 15% to 20%
- Equity
  - Existing or new?

M&A Negotiation

- Importance of negotiating strategy often underestimated
- Posture, style, and other tactics
- Price and terms are important
- The need and desire to transact
- Understand the seller's alternatives

Deal Structuring

Structure is as important as the price

– Assets vs. shares
– Forms and terms of payment
– Management contracts

Risk-based deal structuring

- Holdbacks
- Promissory notes
- Share exchanges
- Earnouts
- Other forms (e.g. majority stake)

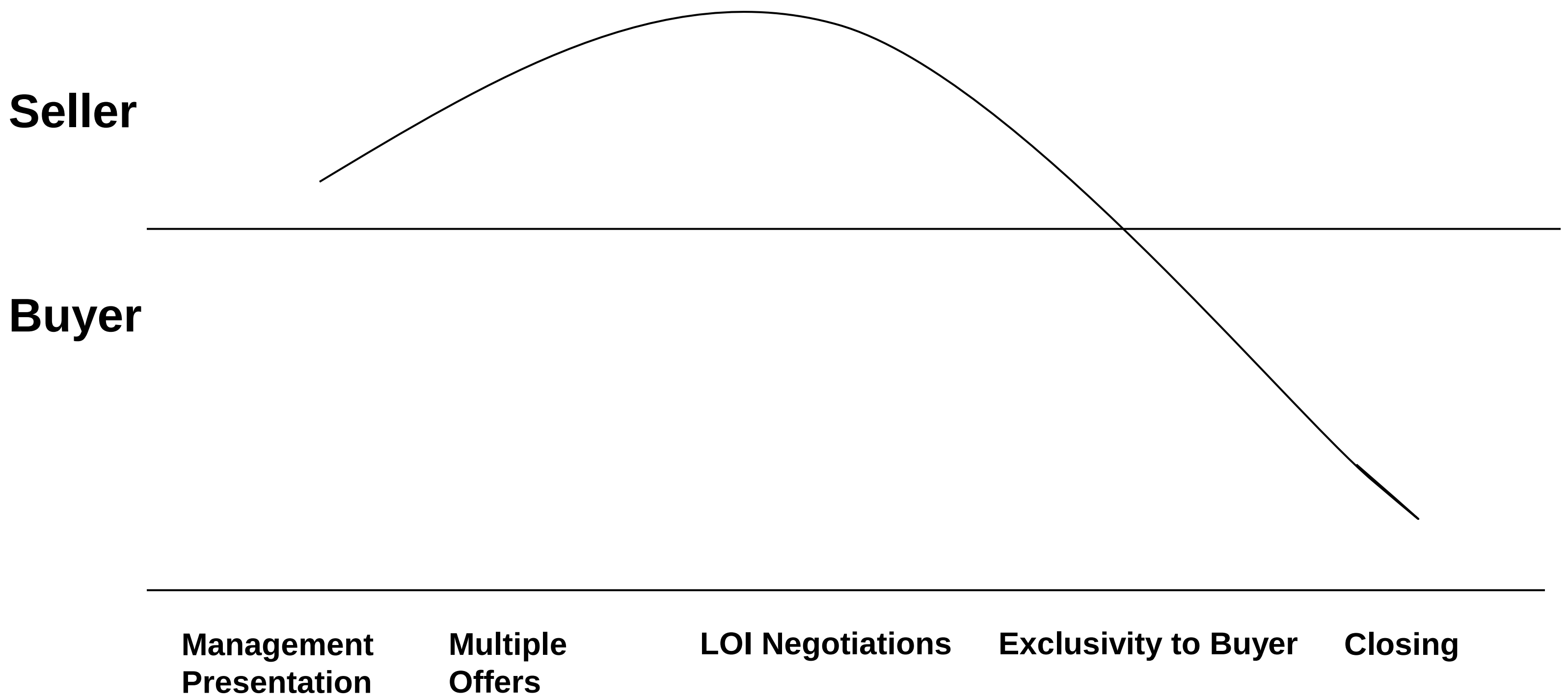
Who Should be Involved in Negotiations

- The negotiation team
  - Internal / external
- Fewer is better (directly)
- External advisors act as buffer
  - subsequent relationship
  - emotional deal killers
  - shadow negotiator
- Authority/competence to recommend deal

The Letter of Intent

- Non-binding except for certain provisions
  - Confidentiality
  - Exclusivity
- A key document in negotiations
- The apex of negotiations
- What to include / exclude
- LOI vs. Expression of Interest

The Buyer/Seller Advantage Curve



Due Diligence

- Legal and audit due diligence
- Verification of facts and assumptions
- Details not previously reviewed
  - Employee details
  - Contracts and agreements
  - Operations
  - Customer / supplier details
  - Financial details
  - Insurance and related claims
  - Legal issues, minute books, etc.

Hidden Issues

- Overvalued assets
  - Slow-moving inventories
  - Receivables
  - Fixed assets (repairs, maintenance)
- Undervalued Liabilities
  - Pensions and post-employment obligations
  - Warranties
  - Contracts and commitments
- Revenue / expense recognition

Due Diligence Renegotiation

- Buyer's side
  - significant issues discovered or interim business issues
  - Lower price vs. change terms
  - When to walk away
- Seller's side
  - 'unsolicited' alternative offer
  - Interim business performance
  - Holding out for more

Purchase Agreement

- Definitive binding agreement
- Contains all aspects of the deal
- Drafted by the buyer's legal counsel
- Normally prepared concurrent with due diligence
- Representations and warranties
- Arbitration clauses

Representations & Warranties

- Best of knowledge vs. Absolute knowledge
- Time period
- Minimums / maximums (baskets and caps)
- Seller covenants

Management Contracts

- Individual shareholders
- Eases transition issues for buyers
- Usually 6 months to 3 years
- Level of involvement to be determined
- May effectively represent a portion of price
- Transition issue for seller?

Non-competition Agreements

- Individual shareholders
- Individual goodwill
- Specifies scope of work, territory and time period
- 2 to 5 years is not uncommon
- Purchase price allocation
  - Tax rules

Closing

- Usually at a lawyers office
- Concurrent with or shortly after execution of purchase agreement
- Exchange of cash, shares, notes, etc.
- Last-minute negotiations
- Post-closing audit

Keys to Successful Integration

- Communication
- Plan with milestones
- Execution / managing the process
- Champion with authority and business savvy
- Plan in advance – during assessment stage
- Identify and deal with issues early
- Getting employee buy-in

Classic Buyer Mistakes

- Overpaying for expected synergies / unrealized synergies
- Compulsion to act / falling in love with 'the deal'
- Inadequate due diligence
- Technical errors in financial analysis & calculations
- Poor integration
- Bitter post-acquisition sentiment
- Management philosophy / cultural differences
- Failure to identify hidden costs
- Failure to anticipate or avoid key personnel turnover

Resources

Visit www.Veracap.com for a variety of publications and other resources