Excellence in Financial Management

Course 7: Mergers & Acquisitions (Part 1)

Prepared by: Matt H. Evans, CPA, CMA, CFM

This course (part 1) provides a concise overview of the merger and acquisition process, including the legal process, federal regulations and due diligence. The purpose of the course is to give the user a solid understanding of how mergers and acquisitions work. This course is recommended for 2 hours of Continuing Professional Education. In order to receive credit, you will need to pass a multiple choice exam which is administered over the internet at www.exinfm.com/training

Published March 2000

Chapter
1

Basic Concepts

Mergers and acquisitions represent the ultimate in change for a business. No other event is more difficult, challenging, or chaotic as a merger and acquisition. It is imperative that everyone involved in the process has a clear understanding of how the process works. Hopefully this short course will provide you with a better appreciation of what is involved.

You might be asking yourself, why do I need to learn the merger and acquisition (M & A) process? Well for starters, mergers and acquisitions are now a normal way of life within the business world. In today's global, competitive environment, mergers are sometimes the only means for long-term survival. In other cases, such as Cisco Systems, mergers are a strategic component for generating long-term growth. Additionally, many entrepreneurs no longer build companies for the long-term; they build companies for the short-term, hoping to sell the company for huge profits. In her book The Art of Merger and Acquisition Integration, Alexandra Reed Lajoux puts it best:

> Virtually every major company in the United States today has experienced a major acquisition at some point in history. And at any given time, thousands of these companies are adjusting to post-merger reality. For example, so far in the decade of the 1990's (through June 1997), 96,020 companies have come under new ownership worldwide in deals worth a total of $ 3.9 trillion - and that's just counting acquisitions valued at $ 5 million and over. Add to this the many smaller companies and nonprofit and governmental entities that experience mergers every year, and the M & A universe becomes large indeed.

M & A Defined

When we use the term "merger", we are referring to the merging of two companies where one new company will continue to exist. The term "acquisition" refers to the acquisition of assets by one company from another company. In an acquisition, both companies may continue to exist. However, throughout this course we will loosely refer to mergers and acquisitions (M & A) as a business transaction where one company acquires another company. The acquiring company will remain in business and the acquired company (which we will sometimes call the Target Company) will be integrated into the acquiring company and thus, the acquired company ceases to exist after the merger.

Mergers can be categorized as follows:

Horizontal: Two firms are merged across similar products or services. Horizontal mergers are often used as a way for a company to increase its market share by merging with a competing company. For example, the merger between Exxon and Mobil will allow both companies a larger share of the oil and gas market.

Vertical: Two firms are merged along the value-chain, such as a manufacturer merging with a supplier. Vertical mergers are often used as a way to gain a competitive advantage within the marketplace. For example, Merck, a large manufacturer of pharmaceuticals, merged with Medco, a large distributor of pharmaceuticals, in order to gain an advantage in distributing its products.

Conglomerate: Two firms in completely different industries merge, such as a gas pipeline company merging with a high technology company. Conglomerates are usually used as a way to smooth out wide fluctuations in earnings and provide more consistency in long-term growth. Typically, companies in mature industries with poor prospects for growth will seek to diversify their businesses through mergers and acquisitions. For example, General Electric (GE) has diversified its businesses through mergers and acquisitions, allowing GE to get into new areas like financial services and television broadcasting.

Reasons for M & A

Every merger has its own unique reasons why the combining of two companies is a good business decision. The underlying principle behind mergers and acquisitions (M & A) is simple: 2 + 2 = 5. The value of Company A is $ 2 billion and the value of Company B is $ 2 billion, but when we merge the two companies together, we have a total value of $ 5 billion. The joining or merging of the two companies creates additional value which we call "synergy" value.

Synergy value can take three forms:

1. Revenues: By combining the two companies, we will realize higher revenues then if the two companies operate separately.

2. Expenses: By combining the two companies, we will realize lower expenses then if the two companies operate separately.

3. Cost of Capital: By combining the two companies, we will experience a lower overall cost of capital.

For the most part, the biggest source of synergy value is lower expenses. Many mergers are driven by the need to cut costs. Cost savings often come from the elimination of redundant services, such as Human Resources, Accounting, Information Technology, etc. However, the best mergers seem to have strategic reasons for the business combination. These strategic reasons include:

- Positioning - Taking advantage of future opportunities that can be exploited when the two companies are combined. For example, a telecommunications company might improve its position for the future if it were to own a broad band service company. Companies need to position themselves to take advantage of emerging trends in the marketplace.

- Gap Filling - One company may have a major weakness (such as poor distribution) whereas the other company has some significant strength. By combining the two companies, each company fills-in strategic gaps that are essential for long-term survival.

- Organizational Competencies - Acquiring human resources and intellectual capital can help improve innovative thinking and development within the company.

- Broader Market Access - Acquiring a foreign company can give a company quick access to emerging global markets.

Mergers can also be driven by basic business reasons, such as:

- Bargain Purchase - It may be cheaper to acquire another company then to invest internally. For example, suppose a company is considering expansion of fabrication facilities. Another company has very similar facilities that are idle. It may be cheaper to just acquire the company with the unused facilities then to go out and build new facilities on your own.

- Diversification - It may be necessary to smooth-out earnings and achieve more consistent long-term growth and profitability. This is particularly true for companies in very mature industries where future growth is unlikely. It should be noted that traditional financial management does not always support diversification through mergers and acquisitions. It is widely held that investors are in the best position to diversify, not the management of companies since managing a steel company is not the same as running a software company.

- Short Term Growth - Management may be under pressure to turnaround sluggish growth and profitability. Consequently, a merger and acquisition is made to boost poor performance.

- Undervalued Target - The Target Company may be undervalued and thus, it represents a good investment. Some mergers are executed for "financial" reasons and not strategic reasons. For example, Kohlberg Kravis & Roberts acquires poor performing companies and replaces the management team in hopes of increasing depressed values.

The Overall Process

The Merger & Acquisition Process can be broken down into five phases:

Phase 1 - Pre Acquisition Review: The first step is to assess your own situation and determine if a merger and acquisition strategy should be implemented. If a company expects difficulty in the future when it comes to maintaining core competencies, market share, return on capital, or other key performance drivers, then a merger and acquisition (M & A) program may be necessary.

It is also useful to ascertain if the company is undervalued. If a company fails to protect its valuation, it may find itself the target of a merger. Therefore, the pre-acquisition phase will often include a valuation of the company - Are we undervalued? Would an M & A Program improve our valuations?

The primary focus within the Pre Acquisition Review is to determine if growth targets (such as 10% market growth over the next 3 years) can be achieved internally. If not, an M & A Team should be formed to establish a set of criteria whereby the company can grow through acquisition. A complete rough plan should be developed on how growth will occur through M & A, including responsibilities within the company, how information will be gathered, etc.

Phase 2 - Search & Screen Targets: The second phase within the M & A Process is to search for possible takeover candidates. Target companies must fulfill a set of criteria so that the Target Company is a good strategic fit with the acquiring company. For example, the target's drivers of performance should compliment the acquiring company. Compatibility and fit should be assessed across a range of criteria - relative size, type of business, capital structure, organizational strengths, core competencies, market channels, etc.

It is worth noting that the search and screening process is performed in-house by the Acquiring Company. Reliance on outside investment firms is kept to a minimum since the preliminary stages of M & A must be highly guarded and independent.

Phase 3 - Investigate & Value the Target: The third phase of M & A is to perform a more detail analysis of the target company. You want to confirm that the Target Company is truly a good fit with the acquiring company. This will require a more thorough review of operations, strategies, financials, and other aspects of the Target Company. This detail review is called "due diligence." Specifically, Phase I Due Diligence is initiated once a target company has been selected. The main objective is to identify various synergy values that can be realized through an M & A of the Target Company. Investment Bankers now enter into the M & A process to assist with this evaluation.

A key part of due diligence is the valuation of the target company. In the preliminary phases of M & A, we will calculate a total value for the combined company. We have already calculated a value for our company (acquiring company). We now want to calculate a value for the target as well as all other costs associated with the M & A. The calculation can be summarized as follows:

Value of Our Company (Acquiring Company)	$ 560
Value of Target Company	176
Value of Synergies per Phase I Due Diligence	38
Less M & A Costs (Legal, Investment Bank, etc.)	(9)
Total Value of Combined Company	$ 765

Phase 4 - Acquire through Negotiation: Now that we have selected our target company, it's time to start the process of negotiating a M & A. We need to develop a negotiation plan based on several key questions:

- How much resistance will we encounter from the Target Company?
- What are the benefits of the M & A for the Target Company?
- What will be our bidding strategy?
- How much do we offer in the first round of bidding?

The most common approach to acquiring another company is for both companies to reach agreement concerning the M & A; i.e. a negotiated merger will take place. This negotiated arrangement is sometimes called a "bear hug." The negotiated merger or bear hug is the preferred approach to a M & A since having both sides agree to the deal will go a long way to making the M & A work. In cases where resistance is expected from the target, the acquiring firm will acquire a partial interest in the target; sometimes referred to as a "toehold position." This toehold position puts pressure on the target to negotiate without sending the target into panic mode.

In cases where the target is expected to strongly fight a takeover attempt, the acquiring company will make a tender offer directly to the shareholders of the target, bypassing the target's management. Tender offers are characterized by the following:

- The price offered is above the target's prevailing market price.
- The offer applies to a substantial, if not all, outstanding shares of stock.
- The offer is open for a limited period of time.
- The offer is made to the public shareholders of the target.

A few important points worth noting:

- Generally, tender offers are more expensive than negotiated M & A's due to the resistance of target management and the fact that the target is now "in play" and may attract other bidders.
- Partial offers as well as toehold positions are not as effective as a 100% acquisition of "any and all" outstanding shares. When an acquiring firm makes a 100% offer for the outstanding stock of the target, it is very difficult to turn this type of offer down.

Another important element when two companies merge is Phase II Due Diligence. As you may recall, Phase I Due Diligence started when we selected our target company. Once we start the negotiation process with the target company, a much more intense level of due diligence (Phase II) will begin. Both companies, assuming we have a negotiated merger, will launch a very detail review to determine if the proposed merger will work. This requires a very detail review of the target company - financials, operations, corporate culture, strategic issues, etc.

<u>Phase 5 - Post Merger Integration</u>: If all goes well, the two companies will announce an agreement to merge the two companies. The deal is finalized in a formal merger and acquisition agreement. This leads us to the fifth and final phase within the M & A Process, the integration of the two companies.

Every company is different - differences in culture, differences in information systems, differences in strategies, etc. As a result, the Post Merger Integration Phase is the most difficult phase within the M & A Process. Now all of a sudden we have to bring these two companies together and make the whole thing work. This requires extensive planning and design throughout the entire organization. The integration process can take place at three levels:

1. <u>Full</u>: All functional areas (operations, marketing, finance, human resources, etc.) will be merged into one new company. The new company will use the "best practices" between the two companies.

2. Moderate: Certain key functions or processes (such as production) will be merged together. Strategic decisions will be centralized within one company, but day to day operating decisions will remain autonomous.

3. Minimal: Only selected personnel will be merged together in order to reduce redundancies. Both strategic and operating decisions will remain decentralized and autonomous.

If post merger integration is successful, then we should generate synergy values. However, before we embark on a formal merger and acquisition program, perhaps we need to understand the realities of mergers and acquisitions.

A Reality Check

As mentioned at the start of this course, mergers and acquisitions are extremely difficult. Expected synergy values may not be realized and therefore, the merger is considered a failure. Some of the reasons behind failed mergers are:

- Poor strategic fit - The two companies have strategies and objectives that are too different and they conflict with one another.

- Cultural and Social Differences - It has been said that most problems can be traced to "people problems." If the two companies have wide differences in cultures, then synergy values can be very elusive.

- Incomplete and Inadequate Due Diligence - Due diligence is the "watchdog" within the M & A Process. If you fail to let the watchdog do his job, you are in for some serious problems within the M & A Process.

- Poorly Managed Integration - The integration of two companies requires a very high level of quality management. In the words of one CEO, "give me some people who know the drill." Integration is often poorly managed with little planning and design. As a result, implementation fails.

- Paying too Much - In today's merger frenzy world, it is not unusual for the acquiring company to pay a premium for the Target Company. Premiums are paid based on expectations of synergies. However, if synergies are not realized, then the premium paid to acquire the target is never recouped.

- Overly Optimistic - If the acquiring company is too optimistic in its projections about the Target Company, then bad decisions will be made within the M & A Process. An overly optimistic forecast or conclusion about a critical issue can lead to a failed merger.

The above list is by no means complete. As we learn more about the M & A Process, we will discover that the M & A Process can be riddled with all kinds of problems, ranging from organizational resistance to loss of customers and key personnel.

We should also recognize some cold hard facts about mergers and acquisitions. In the book The Complete Guide to Mergers and Acquisitions, the authors Timothy J. Galpin and Mark Herndon point out the following:

- Synergies projected for M & A's are not achieved in 70% of cases.
- Just 23% of all M & A's will earn their cost of capital.
- In the first six months of a merger, productivity may fall by as much as 50%.
- The average financial performance of a newly merged company is graded as C - by the respective Managers.
- In acquired companies, 47% of the executives will leave the first year and 75% will leave within the first three years of the merger.

In the book Valuation: Measuring and Managing the Value of Companies, the authors note the following:

> "Even in situations where the acquired company is in the same line of business as the acquirer and is small enough to allow for easy post-merger integration, the likelihood of success is only about 50%."

Do not despair - there is some good news in all of this! The success rate in recent years has improved dramatically. As more and more companies gain experience in the M & A process, they are becoming very successful. In 1997, Mercer Management Consulting released a study which showed that mergers during the 1990's substantially outperformed mergers during the 1980's.

So let us move on and see if we can better understand the nuts and bolts behind mergers and acquisitions.

Chapter

2

Legal and Regulatory Considerations

When one company decides to acquire another company, a series of negotiations will take place between the two companies. The acquiring company will have a well-developed negotiating strategy and plan in place. If the Target Company believes a merger is possible, the two companies will enter into a "Letter of Intent."

The Letter of Intent outlines the terms for future negotiations and commits the Target Company to giving serious consideration to the merger. A Letter of Intent also gives the acquiring company the green light to move into Phase II Due Diligence. The Letter of Intent attempts to answer several issues concerning the proposed merger:

1. How will the acquisition price be determined?

2. What exactly are we acquiring? Is it physical assets, is it a controlling interest in the target, is it intellectual capital, etc.?

3. How will the merger transaction be designed? Will it be an outright purchase of assets? Will it be an exchange of stock?

4. What is the form of payment? Will the acquiring company issue stock, pay cash, issue notes, or use a combination of stock, cash, and/or notes?

5. Will the acquiring company setup an escrow account and deposit part of the purchase price? Will the escrow account cover unrecorded liabilities discovered from due diligence?

6. What is the estimated time frame for the merger? What law firms will be responsible for creating the M & A Agreement?

7. What is the scope of due diligence? What records will be made available for completing due diligence?

8. How much time will the Target Company allow for negotiations? The Letter of Intent will usually prohibit the Target Company from "shopping itself" during negotiations.

9. How much compensation (referred to as bust up fees) will the acquiring company be entitled to in the event that the target is acquired by another company? Once news of the proposed merger leaks out, the Target Company is "in play" and other companies may make a bid to acquire the Target Company.

10. Will there be any operating restrictions imposed on either company during negotiations? For example, the two companies may want to postpone hiring new personnel, investing in new facilities, issuing new stock, etc. until the merger has been finalized.

11. If the two companies are governed by two states or countries, which one will govern the merger transaction?

12. Will there be any adjustment to the final purchase price due to anticipated losses or events prior to the closing of the merger?

M & A Agreement

As the negotiations continue, both companies will conduct extensive Phase II Due Diligence in an effort to identify issues that must be resolved for a successful merger. If significant issues can be resolved and both companies are convinced that a merger will be beneficial, then a formal merger and acquisition agreement will be formulated.

The basic outline for the M & A Agreement is rooted in the Letter of Intent. However, Phase II Due Diligence will uncover several additional issues not covered in the Letter of Intent. Consequently, the M & A Agreement can be very lengthy based on the issues exposed through Phase II Due Diligence.

Additionally, both companies need to agree on the integration process. For example, a Transition Service Agreement is executed to cover certain types of services, such as payroll. The Target Company continues to handle payroll up through a certain date and once the integration process is complete, the acquiring company takes over payroll responsibilities. The Transition Service Agreement will specify the types of services, timeframes, and fees associated with the integration process.

Representations

One very important element within the M & A Agreement is representation by both companies. Both sides must provide some warranty that what has been conveyed is complete and accurate. From the buyers (acquiring firm) viewpoint, full and complete disclosure is critical if the buyer is to understand what is being acquired. Discovery of new issues that have been misrepresented by the seller can relieve the buyer from proceeding with the merger.

From the seller's point of view, full disclosure requires extensive time and effort. Additionally, it is difficult to cover every possible representation as "full and accurate." Therefore, the seller prefers to limit the number of representations within the M & A Agreement. One way of striking the right balance is to establish materiality limits on certain representations. The M & A Agreement will also include language, such as "to the best of the sellers knowledge," in order to alleviate some representations.

Indemnification

Another important element within the M & A Agreement is indemnification. The M & A Agreement will specify the nature and extent to which each company can recover damages should a misrepresentation or breach of contract occur. A "basket" provision will stipulate that damages are not due until the indemnification amount has reached a certain threshold. If the basket amount is exceeded, the indemnification amount becomes payable at either the basket amount or an amount more than the basket amount. The seller (Target Company) will insist on having a ceiling for basket amounts within the M & A Agreement.

Since both sides may not agree on indemnification, it is a good idea to include a provision on how disputes will be resolved (such as binding arbitration). Finally, indemnification provisions may include a "right of sell off" for the buyer since the buyer has deposited part of the purchase price into an escrow account. The Right to Sell Off allows the buyer (acquiring company) to offset any indemnification claims against amounts deferred within the purchase price of the merger. If the purchase price has been paid, then legal action may be necessary to resolve the indemnification.

Confidentiality

It is very important for both sides to keep things confidential before announcing the merger. If customers, suppliers, employees, shareholders, or other parties should find out about the merger before it is announced, the target company could lose a lot of value: Key personnel resign, productivity drops, customers switch to competing companies, suppliers decide not to renew contracts, etc. In an effort to prevent leaks, the two companies will enter into a Confidentiality Agreement whereby the acquiring firm agrees to keep information learned about the Target Company as confidential. Specifically, the Confidentiality Agreement will require the acquiring firm to:

- Not contact customers, suppliers, owners, employees, and other parties associated with the Target Company.
- Not divulge any information about the target's operating and financial plans or its current conditions.
- Not reproduce and distribute information to outside parties.
- Not use the information for anything outside the scope of evaluating the proposed merger.

M & A Closing

Once all issues have been included and addressed to the satisfaction of both companies, the merger and acquisition is executed by signing the M & A Agreement. The buyer and the seller along with their respective legal teams meet and exchange documents. This represents the closing date for the merger and acquisition. The transaction takes place through the exchange of stock, cash, and/or notes. Once the agreement has been finalized, a formal announcement is made concerning the merger between the two companies.

It should be noted that due diligence extends well beyond the closing date. Therefore, actual payment may be deferred until legal opinions can be issued, financial statements audited, and the full scope of Phase II Due Diligence can be completed. It is not uncommon for many conditions to remain open and thus, the M & A Agreement may require amendments to cover the results of future due diligence.

The Regulatory Environment

So far, we have discussed the overall process for mergers and acquisitions as well as some important legal documents. We now need to understand some of the regulations that can affect the merger and acquisition. In the United States, regulations can be divided into three categories: State Laws, Federal Anti-Trust Laws, and Federal Security Laws. Since discussion of state law is beyond the scope of this course, we will focus on federal related laws. The Federal Trade Commission (FTC) and the U.S. Justice Department (USJD) administer federal anti-trust laws. The Securities and Exchange Commission (SEC) administers federal security laws for companies registered with the SEC.

Anti-Trust Laws

One of the most important federal laws is Section 7 of the Clayton Act which stipulates that a merger cannot substantially lessen competition or result in a monopoly. In determining if a merger is anti-competitive, federal agencies will look at the markets served and the type of commerce involved. Several factors are considered, such as size of market, number of competing companies, financial condition of companies, etc.

The size of the newly merged company in relation to the market is very important. The USJD uses an acid test known as the Herfindahl-Hirshman Index (HHI) to determine if action should be taken to challenge the merger. The HHI measures the impact the merger will have on increased concentration within the total marketplace. HHI is calculated by summing the squares of individual market shares for all companies and categorizing market concentration into one of three categories. The three categories are:

<u>Less than 1000</u>: Unconcentrated market, merger is unlikely to result in anti-trust action.

<u>1000 - 1800</u>: Moderate concentration. If the change in the HHI exceeds 100 points, there could be concentration in the marketplace.

<u>Above 1800</u>: Highly concentrated market. If the change in the HHI exceeds 50 points, there are significant anti-trust concerns.

> Example 1 - Determine if a merger will raise anti-trust actions based on the HHI.
>
> Six companies compete in the retail home heating oil market. The six companies have market shares of:

Triple C Oil	10%
Amber Oil	5%
Pacific Oil	20%
American	40%
Testco	5%
BCI Oil	20%

Amber Oil and Testco have decided to merge. Will this merger be viewed as anti-competitive based on the HHI?

Step 1 - Calculate Pre Merger HHI:

Triple C Oil	10 x 10 =	100
Amber Oil	5 x 5 =	25
Pacific Oil	20 x 20 =	400
American	40 x 40 =	1600
Testco	5 x 5 =	25
BCI Oil	20 x 20 =	400
	Pre Merger HHI	2550

Step 2 - Calculate Post Merger HHI:

Triple C	100
Amber / Testco	100
Pacific Oil	400
American	1600
BCI Oil	400
Post Merger HHI	2600

Step 3: Calculate change in points, compare to HHI categories. 2550 - 2660 = 50 point change within third category.

The HHI is above 1800 points and the point change is right at the threshold for significant concern. Amber and Testco should be prepared to defend their merger as not reducing competition.

Notifying the FTC and USJD

The FTC (Federal Trade Commission) and the USJD (United States Justice Department) become involved within the merger and acquisition process by way of the "16 Page Form." The 16 Page Form is filed with the FTC and USJD whenever a merger involves one company with $ 100 million or more in assets or sales and the other company has $ 10 million or more in assets or sales and the transaction involves an offer of $ 15 million or more in assets or stock or the transaction involves more than 50% ownership of a company with $ 15 million or more in assets or sales.

The 16 Page Form requires disclosure concerning the type of transaction and a description of both companies. The 16 Page Form is filed by the acquiring company when it announces its tender offer to acquire the Target Company. Likewise, the Target Company must file a 16 Page Form within 15 days of the filing by the acquiring company.

Security Laws

Companies registered with the Securities and Exchange Commission (SEC) must deal with several schedules whenever a merger takes place. A full discussion of all regulatory requirements is beyond the scope of this course. In any event, here are some highlights that affect many mergers:

<u>Form 8K</u>: Whenever a company acquires in excess of 10% of book values of a registered company, the SEC must be notified on Form 8K within 15 days.

<u>Schedule 13D</u>: Whenever someone acquires 5% or more of the outstanding stock of a public company, the acquisition must be disclosed on Schedule 13D. Six copies of Schedule 13D

must be filed with the SEC within 10 days of acquiring the stock. A registered copy must be sent to the Target Company.

Schedule 13G: Short version of Schedule 13D for cumulative buildup of 5%. If during the last 12 months, no more than 2% of the outstanding stock was acquired and there is no intention of controlling the company, the purchase may be disclosed on Schedule 13G in lieu of Schedule 13D.

Schedule 14D-1 (Tender Offer Statement): When a company makes a tender offer to acquire the stock of another company, the acquiring company must file a Tender Offer Statement (TOC) on Schedule 14D-1. The TOC must disclose:

- Name of target company
- Description of securities purchased
- Any past contact with the target company
- Source of funds to acquire the stock
- Description of plans to change the target company, such as selling off assets.
- Complete set of financial statements of the acquiring company
- Exhibits related to financing of the stock purchase

In cases where a hostile takeover attempt is involved, it is not unusual for the Target Company to contest the TOC. For example, the Target Company may argue that the acquiring firm lacks the necessary financing to complete the tender offer.

Once the acquiring firm has announced the tender offer, it has 5 days to file the TOS. The acquiring firm must hand deliver a copy to the Target Company and any other company that is engaged in acquiring the target company. A copy must also be sent to all exchanges where the Target Company's stock is traded.

Schedule 14D-9: The target company is required to respond to the TOS on Schedule 14D-9 within 10 days of commencement of the tender offer. Schedule 14D-9 must disclose the target company's intentions regarding the tender offer - accept, reject, or no action.

It should be noted that tender offers must remain open for at least 20 days per the Williams Act. Also, if other companies decide to bid for the Target Company, the tender offer period is subject to an extension for a minimum period of 10 days from the date of other tender offers.

Example 2 - Extension of Tender Offer Period

On January 1, 1997, Tri-Star made a tender offer to acquire Lipco. The tender offer will expire in 20 days on January 20, 1997. On January 17, 1997, another company, Selmer, made a tender offer to acquire Lipco. What is the new closing date for Tri-Star's tender offer?

Since a minimum period of 10 days is required for all tender offers, Tri-Star's offer period is extended by another 7 days to cover the 10 day minimum. The new closing date is now January 27, 1997.

Accounting Principles

One last item that we should discuss is the application of accounting principles to mergers and acquisitions. Currently, there are two methods that are used to account for mergers and acquisitions (M & A):

Purchase: The M & A is viewed prospectively (restate everything and look forward) by treating the transaction as a purchase. Assets of the Target Company are restated to fair market value and the difference between the price paid and the fair market values are posted to the Balance Sheet as goodwill.

Pooling of Interest: The M & A is viewed historically (refer back to existing values) by combining the book values of both companies. There is no recognition of goodwill. It should be noted that Pooling of Interest applies to M & A's that involve stock only.

In the good old days when physical assets were important; the Purchase Method was the leading method for M & A accounting. However, as the importance of intellectual capital and other intangibles has grown, the Pooling of Interest Method is now the dominant method for M & A accounting. However, therein lies the problem. Because intangibles have become so important to businesses, the failure to recognize these assets from an M & A can seriously distort the financial statements. As a result, the Financial Accounting Standards Board has proposed the elimination of the Pooling of Interest Method. If Pooling is phased out, then it will become much more important to properly arrive at fair market values for the target's assets.

NOTE: Most Advanced Accounting textbooks will provide comprehensive information about accounting for mergers and acquisitions. A full treatment of this topic is beyond the scope of this Short Course. Readers are advised to refer to an Advanced Accounting textbook for more information about M & A Accounting.

Chapter

3

Due Diligence

There is a common thread that runs throughout much of the M & A Process. It is called Due Diligence. Due diligence is a very detail and extensive evaluation of the proposed merger. An over-riding question is - Will this merger work? In order to answer this question, we must determine what kind of "fit" exists between the two companies. This includes:

Investment Fit - What financial resources will be required, what level of risk fits with the new organization, etc.?

Strategic Fit - What management strengths are brought together through this M & A? Both sides must bring something unique to the table to create synergies.

Marketing Fit - How will products and services compliment one another between the two companies? How well do various components of marketing fit together - promotion programs, brand names, distribution channels, customer mix, etc?

Operating Fit - How well do the different business units and production facilities fit together? How do operating elements fit together - labor force, technologies, production capacities, etc.?

Management Fit - What expertise and talents do both companies bring to the merger? How well do these elements fit together - leadership styles, strategic thinking, ability to change, etc.?

Financial Fit - How well do financial elements fit together - sales, profitability, return on capital, cash flow, etc.?

Due diligence is also very broad and deep, extending well beyond the functional areas (finance, production, human resources, etc.). This is extremely important since due diligence must expose all of the major risk associated with the proposed merger. Some of the risk areas that need to be investigated are:

- Market - How large is the target's market? Is it growing? What are the major threats? Can we improve it through a merger?
- Customer - Who are the customers? Does our business compliment the target's customers? Can we furnish these customers new services or products?
- Competition - Who competes with the target company? What are the barriers to competition? How will a merger change the competitive environment?
- Legal - What legal issues can we expect due to an M & A? What liabilities, lawsuits, and other claims are outstanding against the Target Company?

Another reason why due diligence must be broad and deep is because management is relying on the creation of synergy values. Much of Phase I Due Diligence is focused on trying to identify and confirm the existence of synergies between the two companies. Management must know if their expectation over synergies is real or false and about how much synergy can we expect? The total value assigned to the synergies gives management some idea of how much of a premium they should pay above the valuation of the Target Company. In some cases, the merger may be called off because due diligence has uncovered substantially less synergies then what management expected.

Making Due Diligence Work

Since due diligence is a very difficult undertaking, you will need to enlist your best people, including outside experts, such as investment bankers, auditors, valuation specialist, etc. Goals and objectives should be established, making sure everyone understands what must be done. Everyone should have clearly defined roles since there is a tight time frame for completing due diligence. Communication channels should be updated continuously so that people can update their work as new information becomes available; i.e. due diligence must be an iterative process. Throughout due diligence, it will be necessary to provide summary reports to senior level management.

Due diligence must be aggressive, collecting as much information as possible about the target company. This may even require some undercover work, such as sending out people with false identities to confirm critical issues. A lot of information must be collected in order for due diligence to work. This information includes:

1. Corporate Records: Articles of incorporation, by laws, minutes of meetings, shareholder list, etc.

2. Financial Records: Financial statements for at least the past 5 years, legal council letters, budgets, asset schedules, etc.

3. Tax Records: Federal, state, and local tax returns for at least the past 5 years, working papers, schedules, correspondence, etc.

4. Regulatory Records: Filings with the SEC, reports filed with various governmental agencies, licenses, permits, decrees, etc.

5. Debt Records: Loan agreements, mortgages, lease contracts, etc.

6. Employment Records: Labor contracts, employee listing with salaries, pension records, bonus plans, personnel policies, etc.

7. Property Records: Title insurance policies, legal descriptions, site evaluations, appraisals, trademarks, etc.

8. Miscellaneous Agreements: Joint venture agreements, marketing contracts, purchase contracts, agreements with Directors, agreements with consultants, contract forms, etc.

Good due diligence is well structured and very pro-active; trying to anticipate how customers, employees, suppliers, owners, and others will react once the merger is announced. When one analyst was asked about the three most important things in due diligence, his response was "detail, detail, and detail." Due diligence must very in-depth if you expect to uncover the various issues that must be addressed for making the merger work.

What Can Go Wrong

Failure to perform due diligence can be disastrous. The reputation of the acquiring company can be severely damaged if an announced merger is called-off. For example, the merger between Rite Aid and Revco failed to anticipate anti-trust actions that required selling off retail stores. As a result, expected synergies could not be realized. When asked about the merger, Frank Bergonzi, Chief Financial Officer for Rite Aid remarked: "You spend a lot of money with no results."

A classic case of what can wrong is the merger between HFS Inc and CUC International. Four months after the merger was announced, it was disclosed that there were significant accounting irregularities. Upon the news, the newly formed company, Cendant, lost $ 14 billion in market value. By late 1998, Cendant's Chairman had resigned, investors had filed over 50 lawsuits, and nine of fourteen Directors for CUC had resigned. And in the year 2000, Ernst & Young was forced to settle with shareholders for $ 335 million.

Consequently, due diligence is absolutely essential for uncovering potential problem areas, exposing risk and liabilities, and helping to ensure that there are no surprises after the merger is announced. Unfortunately, in today's fast-paced environment, some companies decide to by pass due diligence and make an offer based on competitive intelligence and public information. This can be very risky.

Results of a Survey on Due Diligence by Braxton Associates:

Duration of Due Diligence - Successful Mergers	4 to 6 months
Duration of Due Diligence - Failed Mergers	2 to 3 months

Reworking the Financials

Certainly one goal of due diligence is to remove distortions from the financial statements of the target company. This is necessary so that the acquiring company can ascertain a more realistic value for the target. There are several issues related to the Balance Sheet:

- Understatement of liabilities, such as pensions, allowances for bad debts, etc.
- Low quality assets - what are the relative market values of assets? Some assets may be overvalued.
- Hidden liabilities, such as contingencies for lawsuits not recognized.
- Overstated receivables - receivables may not be collectable, especially inter-company receivables.
- Overstated inventories - rising levels of inventory over time may indicate obsolescence and lack of marketability. LIFO reserves can also distort inventories.

- Valuation of short-term marketable securities - If the Target Company is holding marketable securities, are they properly valued? If the target is holding investments that are not marketable, are they overstated?
- Intangibles - Certain intangibles, such as brand names, may be seriously undervalued.

Generally, you should expect to see significant differences between book values and market values. If the two are not substantially different, then due diligence should dig deeper to ensure there is no manipulation of values. Likewise, the Income Statement should consist of "quality" earnings. The closer you are to "cash" earnings and not "accrual" type earnings, the higher the integrity of the Income Statement.

Since mergers are often aimed at cutting cost, due diligence might result in several upward adjustments to earnings for the Target Company. This is especially true where the target is a private company where excesses are common. Here are some examples:

- Officer's salaries are excessive in relation to what they do.
- If salaries are high, then pensions will be high.
- Bonuses, travel, and other perks are excessive.
- Vehicles and other assets are unnecessary.
- Family members are on the payroll and they play no role in running the business.
- Consultants with strong ties to management are providing unnecessary services.

The objective is to get back to real values and real profits that will exist after the merger. Once all necessary adjustments have been made, a forecast can be prepared.

Going Beyond the Financials

As we previously noted, due diligence must be broad and deep. This includes things like cultural and human resource issues. It is these types of "people" issues that will be extremely important when it comes time to actually integrate the two companies. Therefore, due diligence helps set the foundation for post-merger integration.

Cultural due diligence looks at corporate cultures and attempts to ascertain an organizational fit between the two merging companies. Each company will have its own culture, derived from several components - corporate policies, rules, compensation plans, leadership styles, internal communication, physical work environment, etc. Cultural due diligence attempts to answer the question - To what extent can the two companies change and adopt to differences between the two corporate cultures? The wider the cultural gap, the more difficult it will be to integrate the two companies. Consequently, cultural due diligence identifies issues that are critical to integration and helps management plan necessary actions for resolving these differences before the merger is announced.

Human resource due diligence attempts to evaluate how people are managed between the two companies. Several issues need to be analyzed:

- How do we continue to maximize the value of human resource capital?
- What is the appropriate mix of pay and benefits for the new organization?
- What incentive programs are needed to retain essential personnel after the merger is announced?

- How are employees rewarded and compensated by the Target Company?
- How does base pay compare to the marketplace?
- How do we merge pension plans, severance pay, etc.?

It is very important to get your Human Resource Department involved in the merger and acquisition process early on since they have strong insights into cultural and human resource issues. Failure to address cultural, social, and human resource issues in Phase II Due Diligence is a major reason behind failed mergers. As one executive said: "We never anticipated the people problems and how much they would prevent integration." Therefore, make sure you include the "people" issues in Phase II Due Diligence (which kicks-in once the Letter of Intent is signed). This point is well made by Galpin and Hendon in their book The Complete Guide to Mergers and Acquisitions:

> In an era of widespread acknowledgement that mergers entail disproportionate risks and failures, the surprising fact is not that "culture" should become such a critical issue during integration, rather what is surprising is that organizational culture and other issues essential to integration have not yet become more central to executive-level deal making.

Reverse Mergers

Before we leave due diligence and dive into valuations (covered in part 2 of this short course), one area that warrants special attention when it comes to due diligence is the Reverse Merger. Reverse mergers are a very popular way for small start-up companies to "go public" without all the trouble and expense of an Initial Public Offering (IPO). Reverse mergers, as the name implies, work in reverse whereby a small private company acquires a publicly listed company (commonly called the Shell) in order to quickly gain access to equity markets for raising capital. This approach to capitalization (reverse merger) is common practice with internet companies like stamps.com, photoloft.com, etc.

For example, ichargeit, an e-commerce company did a reverse merger with Para-Link, a publicly listed distributor of diet products. According to Jesse Cohen, CEO of ichargeit, an IPO would have cost us $ 3 - 5 million and taken over one year. Instead, we acquired a public company for $ 300,000 and issued stock to raise capital.

The problem with reverse mergers is that the Shell Company sells at a serious discount for a reason; it is riddled with liabilities, lawsuits, and other problems. Consequently, very intense due diligence is required to "clean the shell" before the reverse merger can take place. This may take six months. Another problem with the Shell Company is ownership. Cheap penny stocks are sometimes pushed by promoters who hold the stock in "street name" which mask's the true identity of owners. Once the reverse merger takes place, the promoters dump the stock sending the price into a nose-dive. Therefore, it is absolutely critical to confirm the true owners (shareholders) of shell companies involved in reverse mergers.

Course Summary

Mergers and acquisitions are among the most difficult of business transactions. There is no shortage of stress. All of a sudden a new company must be formed with:

- Newer and more ambitious financial goals.
- Quicker turnaround times for growth.
- Restructuring of departments and the old company.
- Introduction of cultural differences.
- Higher rates of employee turnover.
- Lower levels of productivity.
- Communication problems.

There are numerous reasons why companies decide to merge. Some studies indicate that companies merge for improving efficiencies and lowering costs. Other studies show that companies merge to increase market share and gain a competitive advantage. The ultimate goal behind a merger and acquisition is to generate synergy values. Good strategic planning is the key to understanding if synergy values do in fact exist. A well-researched and realistic plan will dramatically improve the chances of realizing synergy values.

Several legal documents will solidify the merger and acquisition process, including a Letter of Intent, which scrutinizes the proposed merger and the Merger & Acquisition Agreement, which finalizes the deal.

Mergers are also subject to government regulation. One such regulation is anti-trust which attempts to prevent companies from forming a monopoly. In a competitive marketplace, companies sell products and services where prices equal marginal costs. This results in an industry characterized by low prices and high levels of production. An industry characterized by a monopoly allows the company to produce at lower levels and higher prices to the customer.

The main control within the merger and acquisition process is Due Diligence. Due diligence obtains as much information as possible about the target company and attempts to build a comparison between the target company and the acquiring company to see if there is a good fit. If there is a good fit, there is the possibility that a merger between the two companies will improve growth, market share, earnings, etc. One area that should not be overlooked is social and cultural issues. These "people" related issues will become extremely important when it comes time to actually combine or integrate the two companies.

NOTE: This Short Course is continued with Part 2, consisting of: Chapter 4 - Valuation Concepts & Standards, Chapter 5 - The Valuation Process, Chapter 6 - Post Merger Integration, and Chapter 7 - Anti Takeover Defenses.

Final Exam

Select the best answer for each question. Exams are graded and administered by installing the exe file version of this course. The exe file version of this course can be downloaded over the internet at www.exinfm.com/training.

1. Etco Energy and Baltic Energy have decided to merge. Both companies provide similar products and services. This type of merger is called a:

    a. Diagonal Merger

    b. Conglomerate

    c. Horizontal Merger

    d. Vertical Merger

2. Synergy values are the additional values that companies realize through a merger and acquisition. Synergy values can take three forms. Generally speaking, the most significant and common form of synergy is:

    a. Higher Cost of Capital

    b. Lower Expenses and Cost

    c. Higher Production Efficiencies

    d. Lower Cost of Capital

3. Once a company completes the Pre-Acquisition Review, the next phase within the merger and acquisition process is to:

    a. Search and screen target companies

    b. Integrate the two companies

    c. Initiate Phase II Due Diligence

    d. Execute a Merger & Acquisition Agreement

4. Many mergers begin through a series of negotiations between the two companies. If the two companies decide to seriously investigate the possibility of a merger, they will launch Phase II Due Diligence and execute a:

    a. Post Merger Contract

    b. Formal Joint Conference

    c. Merger & Acquisition Agreement

d. Letter of Intent

5. Either party in a merger and acquisition may be entitled to indemnification because of a significant misrepresentation. Indemnification is usually not due until a certain threshold has been reached. This threshold amount is often called the:

   a. Reciprocal Amount

   b. Basket Amount

   c. Striking Price

   d. Closing Rate

6. You have been asked to determine if a proposed merger between Dystan and Systel could raise anti-trust concerns with the U.S. Justice Department. Based on market research, you have determined that all of the competing companies have the following market shares:

Company	Market Share
Dystan	10%
Fabco	20%
Lytmar	30%
Systel	10%
United	10%
Zabor	10%

   Using the Herfindahl-Hirschman Index (HHI) as your test, the point change between the pre-merger HHI and the post merger HHI is:

   a. 50 points

   b. 100 points

   c. 200 points

   d. 350 points

7. On March 3, 1998, Miser Steel made a tender offer to acquire Reliance Steel. Miser's tender offer is set to expire on March 23, 1998. On March 21, 1998, another company called Ohio Steel made a tender offer to acquire Reliance Steel. Based on consideration of Ohio Steel's tender offer, the closing date for Miser Steel's tender offer is:

   a. March 21, 1998

   b. March 23, 1998

   c. March 25, 1998

   d. March 31, 1998

8. Due diligence requires the collection of a lot of information. Which of the following information types would be **least** important for due diligence to work properly?

    a. Employment Records of Target Company

    b. Property Records of Competing Companies

    c. Financial Records of Target Company

    d. Property Records of Target Company

9. Due diligence will attempt to restate financial statements in relation to what will take place after the two companies merge. One area of particular concern as it relates to the Balance Sheet is:

    a. Proper Valuation of Cash

    b. Par Value Assigned to Stock

    c. Selection of Depreciation Methods

    d. Possible Understatement of Liabilities

10. Due diligence is particularly important in the case of a reverse merger since it is necessary to "clean the Shell Company." One important aspect of cleaning the Shell Company is to:

    a. Confirm ownership of the Shell Company

    b. Identify cultural and social issues

    c. Plan for long-term integration

    d. Evaluate human resource capital