M&A Best Practices

"Twelve Best Practices of a World Class Corporate M&A Program Which Will Help Navigate Common Pitfalls"

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About the Author

Rob Helfrich is a sought after subject matter expert on the various aspects of developing corporate strategy and executing inorganic initiatives. His world class experience spans over 20 years, including corporate business development roles at organizations including Johnson & Johnson, United Technologies, Corning and Welch Allyn. He is a corporate business development professional with expertise crafting corporate strategy and leading domestic and international acquisitions, divestitures and partnering. He has successful record including foreign transactions and a proven ability to lead projects for multi-national entities and world class Fortune 500 organizations. Rob has successfully led the corporate development process which culminated in the integration of a variety of transactions in several industries, including medical device, telecommunications and HVAC.

As Director of Corporate Development at Welch Allyn, he proactively managed all aspects of the corporate business development from strategy development to target identification, valuation, negotiation, due diligence, deal close. Rob successfully completed a variety of license, supply, divestiture and distribution deals in support and development of Welch Allyn's Advanced Technology, Core Products, Cardiopulmonary and Patient Monitoring business unit strategies. Rob also completed the Company's first acquisition in Asia.

Prior to joining Welch Allyn, Rob was Manager of Business Development for Carrier Corporation's North American Operations. While at Carrier, he led strategy development and inorganic execution activities for the Commercial Applied Equipment and Service division which resulted in several successful ventures including new market entries, manufacturing concerns and sales organizations.

Helfrich received his B.S. in Business Administration from Valparaiso University in Valparaiso, IN. He received his MBA from Lehigh University in Bethlehem, PA. At Lehigh University, he was inducted into Beta Gamma Sigma, the international honor society. He also completed an executive program in corporate strategy from the University of Chicago Booth School of Business.

Executive Summary

By institutionalizing the "Twelve Best Practices of a World Class Corporate M&A Program" provided within this whitepaper, an organization would likely avoid the common pitfalls which cause an acquisition to fail. It is imperative to note the cost of failure can be quite significant. Once acquired and subsequently integrated, a deal cannot be unwound. Significant value for the acquirer can be essentially destroyed not only through the write-down of impaired goodwill, but also through restructurings and discontinued operations. The risk of failure is too great not to ensure the proper planning and processes are religiously utilized which not only greatly reduce the risk of failure, but also ensure the intended synergies are fully realized.

Many of the best practices described in this paper involve managing an effective process. This is not a coincidence. Understanding and managing an effective M&A process, from early strategy through integration, will almost always insure the goals and objectives of the acquisition are met or exceeded.

Why Deals Fail

Within contemporary business literature, there are numerous statistics which estimate the failure rate of corporate acquisitions. Many such studies cite greater than 50% failure rates. And there are a variety of reasons identified. A quick Google search will likely uncover a long list of common issues. In a 2011 Harvard Business Review article, Clayton Christensen suggested the failure rate is somewhere between 70% and 90%. The proposed the root cause was identified to be "executives incorrectly match candidates to the strategic purpose of the deal, failing to distinguish between deals that might improve current operations and those that could dramatically transform the company's growth prospects. As a result, companies too often pay the wrong price and integrate the acquisition the wrong way"[i]

Another of many examples is provided within an article published by Forbes. The article, Why Half of All M&A Deals Fail, and What You Can Do About It[ii], highlights several concepts to consider when considering an acquisition. These concepts include:

- Do you have sufficient management capacity to take on the integration process?
- Have you thoroughly assessed the culture of your target acquisition?
- Is the deal in line with your corporate strategy?
- Is the deal priced so that you can afford to pour adequate resources into the integration?
- Is the acquisition, along with all the costs and risks, a better choice than all other alternatives?

Twelve Best Practices of a World Class Corporate M&A Program

The primary root cause for many acquisition failures is ineffective process management from initial strategy development through integration. Many of the best practices discussed within this paper require the appropriate resources within the organization to be able to manage the corporate development process inclusive of early strategic planning, inorganic growth plans, acquisition business plan, valuation models, due diligence, integration planning and post-audit reviews. Ideally, internal resources, such as a corporate development team, are utilized to manage the entire acquisition process. Again, the primary root cause to many acquisition failures is ineffective process management from early strategy development through integration. Many middle-market acquirers may not have the deal flow to support hiring an internal corporate development team. If pursuing an inorganic strategy without an internal corporate development resource, consider a small multifunctional team to engage very early in the strategy process. Such a team (no greater than three or four) may consist of high level managers selected from marketing, finance and legal. Also, consider outside consulting assistance with experience in corporate development process in contrast to investment banking.

The best practices reviewed within this whitepaper provide concepts which will help an acquirer avoid many pitfalls. By instituting these practices, the likelihood for a successful acquisition will far exceed the commonly cited failure rates.

Strategy Development

The key to developing a successful inorganic strategy is to be as specific as possible early in the corporate strategy cycle. "Acquisitions are not a strategy in itself, rather a tool to achieve a strategy". As an example, many organizations state their inorganic strategy as simply growing top line revenue by an incremental percentage through acquisitions. Growth through acquisitions. This is not a strategy, rather a simple goal or a desired mission. The results can be disastrous. Without specifying why inorganic growth is necessary and how it is to be achieved, an organization could spend significant resources chasing projects and deals that may not fit with either the business or its goals. An inorganic strategy often starts by defining the gap analysis between the inorganic and organic objectives. For example, a company may have a strategy to expand their products or services into an adjacent market. The gap to achieve the organic objectives is the company's lack of channel or distribution. The basis of the inorganic strategy could then be acquiring a company with a strong distribution and sales organization in the new market.

Engaged Strategic Execution

It's suggested acquisitions often fail due to not executing a strategy or developing a business plan. Rather, they focus entirely on completing the transaction. Without an effective process, acquisitions often focus entirely on the transaction and ignore developing the underlying business plan. As a result, the acquirer often cannot appropriately value the deal. For example, how would an acquirer know if they overpaid if they don't quantify the risks and synergies identified in the business plan? Also, what impact may integration have on the value of the deal?

There are no short cuts. Growth through inorganic projects start and conclude with a well-conceived strategy. Too often, acquisitions occur simply because a company wants to sell. The acquisition suddenly becomes "strategic" for the mere fact it is available. To effectively pursue, the potential acquirer needs to answer whether the target fits with the current growth strategy. If there is weak alignment and decide to continue, the acquirer should determine the opportunity cost of other projects or strategies not pursued.

A great example of why early strategy development is so critical occurred early in my career. Carrier Corporation, a leading global HVAC equipment manufacturer, was being outsold in its commercial market given its lack of custom solutions. As an initial strategy, executive management desired to quickly acquire a custom solutions manufacturer. However, early analysis determined success required salesforce skills to sell "upstream" to design build contractors. Carrier's sales force was very weak in this function and customer segment. The corporate development and strategy team thereafter developed a

highly comprehensive plan whereby multiple acquisitions and partnerships would be pursued to acquire both the custom manufacturing capability as well as the sales skills. The project resulted in several successful acquisitions. Had the initial strategy to simply acquire a custom manufacturer been pursued, without obtaining the requisite sales skills, the project very likely would not have met its objectives.

Insure the proper resources are available to develop and execute the inorganic plan. Identify early the executive champion. If the strategy is to expand the sales channel through acquisiton, make certain the Vice President of Sales and Marketing is on-board and engaged. Assign a "high-performing" manager or director from the executive champion's organization to help lead the effort. If the organization does not have a corporate development function to manage the process, consider forming a small "deal team" to develop and execute the plan. Keep it small and multifunctional. Perhaps a resource from marketing, finance and legal. Consider utilizing outside consulting resources experienced with managing the M&A process.

In many cases, buy-side investment banking engagements often fail to provide sufficient support to effectively manage the entire process. Bankers are often helpful for identifying targets, making introductions and rudimentary valuations. However, they often fall short on critical requirements such as integration planning and identifying risks and synergies. The simple fact is an acquirer will typically know their business better than an outside party and will also own the integration and strategic objectives post acquisition.

Creative Deal Making

Inorganic growth is often multi-dimensional. The focus should always be "how can we achieve the goals of our strategy". An acquisition may not always be the appropriate structure and expose the company to unnecessary risk, liabilities and loss of value. If the strategic objective is to grow a certain market segment through innovation, perhaps licensing intellectual property or a development agreement with the target is a better alternative. Creativity within an acquisition is often useful to conclude negotiations. When two parties differ on price, well-structured contingent payments often fill the gap.

A robust valuation model is often very helpful in framing deal structures. Independently quantifying the operational and market synergies prevents overpaying. Knowing how much synergy value you can give away to close a deal is critical to a successful program. Without it, flying blind.

Define Success

Incentivizing those responsible for pursuing an inorganic strategy can be problematic. Unless the organization is pursuing a roll-up strategy, rewarding on volume of deals completed could become counter-productive. Quantity versus quality? Better to complete one or two successful deals versus unwinding multiple failures. Quantitative incentives for completed deals often do not reward appropriate behavior. For example, the true impact and success of closing a $100 million acquisition within the annual employee performance period, will very likely not be known until future periods. Did the deal meet its strategic expectations? Rewarding those for closing the deal could result in a

performance bonus on a deal that ultimately fails and results in significant financial losses and liabilities in future periods.

Alternatively, consider defining success through qualitative measurements. **Successful execution of an inorganic strategy or an acquisition is often hinges on how well a process was implemented.** Was a comprehensive business plan developed which detailed the integration, valued independent synergies, identified and quantified the risks? Did the due diligence effort validate or verify the business plan? How effectively were the deal team and due diligence resources managed? Incentivizing effective project and process management will most certainly increase the odds of a successful deal.

Reward Failure

Failure should never be defined as walking away from a deal. Additionally, those incentivized for completing a deal should also receive similar incentives for killing it! This insures an impartial and unemotional pursuit of an effective process.

An interesting example of rewarding failure is the current innovation process at Corning, Inc. Corning refocused its efforts as a high technology, innovative company after near collapse following the telecommunication crash of 2001. They were hard hit and the market erased over $85 billion of Corning's market capitalization. Their stock went from a high of $109 to a low of $1.33. To survive and reinvent themselves, they determined they needed to drive incremental revenue through innovation. Their mantra became "fail fast, fail early". Managers were expected to fail and were incentivized to do so. The result was an ability of an organization to effectively manage its risk to evaluate many opportunities. As a result, Corning was able to quickly identify and percolate those projects which have the highest potential for success. Corning now attributes over 75% of its revenue from projects which commenced within the past five years.

"Fail fast, fail early" applies well to pursuing acquisition targets. Conducting preliminary due diligence on a target early in the process, often after the letter-of-intent is signed, is an effective best practice which may ensure problematic issues are identified early. The acquirer can either adjust the valuation, determine how to mitigate the issue or terminate the project. If it's a "deal killer", early identification through preliminary due diligence will avoid the significant expense and resources which will be required to continue the project. Preliminary due diligence consists of defining those items which are critical to the value of the deal, prior to pursing a focused and specific due diligence effort. For example, if the project hinges on the strength of the seller's intellectual property, conducting a patent evaluation very early in the process may be prudent. Often preliminary due diligence cannot be pursued until after the letter-of-intent phase given the need to access confidential data.

Acquisitions often take on a "life of their own". Especially given the significant amount of time and work invested by executives and managers in the organization. If significant issues are uncovered, the most appropriate way to communicate to executive management is to quantify the impact. Can the issue be quantified as a sensitivity within the discounted cash flow model? How much value could be at risk. Quantifying the issues will help inform executive management and hopefully drive the appropriate decision.

Own the Process

For those leading the deal team, as a best practice, it is imperative to discriminate between "owning the project" and "owning the process". The focus should always be on the effective process management. Religious adherence to process will ensure the leadership, deal team and/or corporate development staff remain impartial and emotionally detached. **The underlying premise of the deal team should always be to provide timely and accurate information to allow executive management to make fully informed decisions.** Effective process management will significantly mitigate the risks associated with acquisitions. Due diligence is a perfect example. Quite often the less experienced, occasional acquirer will focus their due diligence to only functional areas; finance, regulatory, human resources, operations, etc. Rather in addition to the functional due diligence, the review should include validating the business plan, integration, valuation, synergies and risks. This would assume there exists a process for developing the comprehensive business plan in the first place.

Proactive versus Reactive Target Search

An effective execution of an inorganic strategy will always result in a proactive search for targets which specifically meet the requirements (selection criteria) of the strategy. Sounds logical. By developing a comprehensive business plan and strategy, the acquisition selection criteria should be easily drafted. What are the objectives of the strategy and what does the acquisition need to provide to ensure the specific goals are met? Make a list and draft your selection criteria.

Don't let the "reactives" get in the way of pursuing your proactive targets. Many corporations, notably those with significant market presence, get inundated with solicitations from other companies, inventors, bankers and brokers. A corporate development team can quickly become overwhelmed processing these various "reactive" solicitations often to the detriment of pursuing a proactive target search. However, not all reactive solicitations are bad. In fact, they may fit a future strategy or illuminate a new technology or future market opportunity.

Screen the reactives against your strategic objectives. This should allow an executive to quickly process whether an opportunity is a "fit". Always catalog the inquiry and capture who was involved in the review, what disclosures were made, was a non-disclosure agreement executed, and what was the disposition of the opportunity. There are commercial software solutions available such as ideaPoint (www.idea-point.com) which can help process and capture reactive opportunities. Such software was particularly useful in a situation whereby the CEO of a company which I was employed was approached during a trade show by a very persistent inventor. Not privy to every solicitation, the CEO was able to quickly pull up the file remotely online and determine who was involved in the review and the reasons why the opportunity was not pursued further. This saved significant time reinvestigating the opportunity as well as communicated a consistent message by the CEO to the inventor.

Triangulate the Valuation

Discounted cash flow (DCF) models are the traditional and accepted methodology for valuing deals. Applying DCF techniques are also well suited for quantifying the various components of the business

plan. What is the incremental revenue and expense forecast anticipated to be enjoyed post-close? The DCF model can also provide sensitivity analyses which can help frame the value of the acquisition. What are the upside and downside assumptions and their impact on the value?

However, as a best practice, don't rely on the DCF model as the only determinate of value. Although it's a powerful tool, DCF does have its drawbacks. Mathematically, the most significant criticism is that a large portion of the value is often determined after the forecasted period. The terminal value is intended to capture the steady-state cash flows beyond the forecasted period into perpetuity. Careful consideration needs to be given to applying any growth rate in the terminal value calculation. A small perpetuity growth rate could cause the terminal value to account for greater than fifty percent of the total discounted cash flow. In other words, the DCF model value may be highly dependent upon cash flows which would occur beyond a five or ten-year forecast.

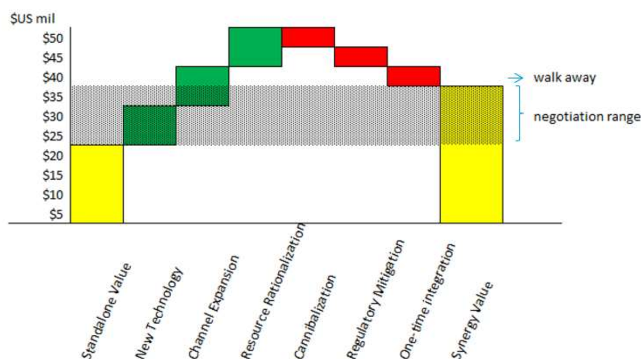
Given some of the drawbacks of the DCF methodology, it's helpful to triangulate the valuation with other techniques. Another common approach is to evaluate comparable transactions. Within the target industry, identify other acquisitions which had previously closed. One can then compare the DCF valuation to the "multiples analysis" of prior deals. For example; what is the average enterprise value to sales (EV/Revenue) and earnings (EV/EBITDA). If the multiples calculated from the base DCF model are in line with the industry comparable transactions, rest assured the DCF model is reasonably accurate. Comparable transactions are also useful if the target company had completed a few publically disclosed transactions themselves. This may help illuminate the seller's price expectations. There are several online resources available to quickly provide and compute a comparable transactions analysis. The most common source is CapitalIQ. (www.capitaliq.com).

Value the Impacts

Perhaps the most significant benefit of conducting a DCF analysis is the ability to perform sensitivity analyses as well as value independent impacts of the business plan. This can be an incredibly powerful analysis which can facilitate effective negotiations. What is the impact on the DCF valuation of the various revenue synergies such as commercializing a new technology acquired from the target? What is the impact of operational synergies such as consolidation? Also, what are the impacts of various issues identified in due diligence?

Expected Value can also be determined if the impacts are calculated. By applying a risk percentage to each impact and summing the result with the standalone or base DCF case, an expected value can be provided. Expected Value can help frame the "walk away" price. It essentially is the risk adjusted total value of the acquisition, inclusive of the anticipated synergies and issues.

Waterfall charts are the most effective way to both illustrate and communicate the value of various impacts to the business plan. Again, it's a useful tool to frame negotiations given it identifies the impacts of the synergies and issues independently as well as their effect on total value. To the right is an example.



Early Integration Planning

One common pitfall often encountered when pursuing an acquisition is not drafting the integration plan early in the process. Often companies will wait until the definitive agreements are near completion to commence integration planning. Reasons often cited are to contain the number of employees within the organization with knowledge of the deal as well as considering the target to be "stand alone", post-close. The fact is, there is no such thing as "no integration". It's just a matter of degree. Human resources policies, procedures, information systems and accounting are all often required integration components within any acquisition.

Early integration planning is critical for the following reasons:

1. To properly value any deal, quantifying the expense, resource requirements and timing is a vital requirement to include within the initial valuation model. Without quantifying the integration requirements, the acquirer is at considerable risk of overpaying.
2. Understand your integration requirements **before** conducting due diligence. Armed with an integration plan, due diligence provides an excellent opportunity to validate or improve the plan. For example, who are the key critical employees of the target company you wish to employ, post-acquisition and are there any red flags in their personnel file? Do they have employment agreements? Compensation plans? Other common examples are whether the information systems are compatible? If planning to consolidate operations, are manufacturing lines relocatable? Are the potential severance liabilities sufficient?

Validate the Plan

Due diligence serves two purposes. First, functional review and analysis. Second, validate the business plan. Will the deal achieve the synergies and goals detailed in the plan? During the process, the business plan is a living document. It starts with an executive briefing paper which outlines its strategic fit. Once approved, the deal team expands the executive briefing paper and begins to develop the comprehensive business plan. The plan typically includes the strategic intent, detailed valuation, preliminary integration, and deal structure design. Due diligence will validate and further expand the business plan. Where applicable, the issues identified during due diligence would be quantified. What is the impact on the valuation? What is the mitigation plan for the identified issues?

Through the process, the business plan evolves and becomes the "bible" of the deal. It captures the results of due diligence, incorporates the integration plan and becomes the document to measure the future success of the project.

Post Audit

Post-audits are an effective management tool which can surface integration issues early, provide "lessons learned", and measure the success of the program. The suggested time frame for post audits should be quarterly first twelve months, annually thereafter. Having early post audits can help monitor integration activities including the initial 100-day Integration Plan.

The comprehensive business plan serves as the basis of the post audit. At this point, the comprehensive business plan is a compilation of all the analysis and activities which supported the project. At a minimum, it would include the strategy, valuation models, due diligence results and risk mitigations and integration plan. The post -audit can identify how well anticipated synergies are being achieved. It is a much more detailed conversation then whether the project is meeting its forecast as developed in the valuation model. By focusing on the anticipated synergies provided within the detailed business plan, management can ensure the necessary and timely actions are taken to ensure the overall success of the project.

Conclusion

The twelve best practices provided within this white paper provide insights and guidelines to ensuring a successful and effective inorganic growth plan, primarily through acquisition. It is intended to provide an appreciation of the necessary activities which can insure success. Too many times acquirers ignore the process and focus on just completing the transaction, believing they can manage through any problems that may arise, post-close. Also, many middle market companies may not have the inorganic deal flow to support hiring an internal corporate development resource to manage the process. A world-class approach would ensure the project is guided by a process which includes a well-conceived, comprehensive plan, all-inclusive valuation models, risk assessments and integration planning. It is crucial an organization identifies the internal personnel or external consulting resources who will be responsible for managing the comprehensive acquisition process well before pursuing a target.

An underlying theme of all the twelve best practices is effective process management. A successful corporate development organization will always focus on the process versus the project. It is imperative the acquisition process is managed well in an impartial manner. This will ensure all aspects of the project are vetted, whether a positive or negative consequence.

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[i] Harvard Business Review, March 2011. The Big Idea: The New M&A Playbook. Clayton M. Christensen, Richard Alton, Curtis Rising, Andrew Waldeck.

[ii] Forbes, March 19, 2012. Why Half of All M&A Deals Fail, and What You Can Do About It. Robert Sher