GROWTH THROUGH MERGERS AND ACQUISITIONS

by

Stephen Wade
Master of Information Management, Queensland University of Technology 2006
Bachelor of Communications, Bond University 2000

PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF
THE REQUIREMENTS FOR THE DEGREE OF
MASTER OF BUSINESS ADMINISTRATION

In the Master of Business Administration, Management of Technology Program
of the
Faculty
of
Business Administration

© Stephen Wade, 2011

SIMON FRASER UNIVERSITY
Summer 2011

All rights reserved. However, in accordance with the Copyright Act of Canada, this work
may be reproduced, without authorization, under the conditions for Fair Dealing.
Therefore, limited reproduction of this work for the purposes of private study, research,
criticism, review and news reporting is likely to be in accordance with the law,
particularly if cited appropriately.
Approval

Name: Stephen Wade
Degree: Master of Business Administration
Title of Project: STRATEGIC AND FINANCIAL GROWTH THROUGH MERGERS AND ACQUISITIONS

Supervisory Committee:

Dr Michael Parent
Senior Supervisor

Dr Elicia Maine
Second Reader

Date Approved: ____________________________
Abstract

As North America recovers from the effects of the 2008 recession, mergers and acquisitions (M&A) transactions are beginning to grow in popularity. Financing is becoming more readily available as investors seek opportunities in both strategic and financial M&A deals. In addition, the availability of businesses for sale is predicted to increase exponentially due to baby boomer retirement. The purpose of this report is to review and analyse the current M&A market and determine where the greatest opportunity lies for M&A practitioners in 2011 and 2012.

Keywords: Mergers and acquisitions; M&A; strategic buyer; financial buyer; finance; North America
Executive Summary

This report reviews and analyses the current state of M&A with a focus on North America. It examines the hazards of M&A and suggests ways to mitigate the risks of M&A failure to create value, as well as strategies to increase chances of success.

A consideration of the factors that contribute to increased M&A activity suggests that 2011 and 2012 are likely to be the years in which the next period of M&A boom occurs. Moneylenders are becoming more adventurous with capital. Global interest rates are low, and businesses have been holding back on potential transactions until the economy recovers.

In the U.S. alone, it is estimated that 8 million privately held companies will change hands in the next ten years, due to baby boomer retirements. The next generation has shown significantly less interest than earlier generations in continuing to own family businesses, and this change is expected to create a dramatic increase in the number of companies for sale.
Data shows that the fluctuation in the number of strategic buyer transactions over time is much greater than the fluctuation in the number of financial buyers. Typically the number of financial buyers ranges between 3% and 9% of total transactions. During the recession, the number of strategic transactions varied greatly while financial transactions remained fairly steady. From this data we can expect that the largest growth sector will be strategic buyers coming out of the 2008 recession.

Deal structure and financing will become increasingly creative in 2011 & 2012. Acquisitions will be funded by a combination of methods to diversify risk for lenders while also giving buyers flexibility. This trend will continue as cautious investors and lenders look to hedge risks and maximize returns through creative deal financing. Private equity and managed investment funds are groups who have significant capital that they must put to work in the near future and hence are likely to consider creative options. Over the next 4-6 years, PE groups will, therefore, be a significant source of financing for M&A transactions.

A review of M&A literature reveals that there are key elements that determine M&A success. Unfortunately, these are often ignored, leading to lost value. These elements include:

1. A clear and thoughtful strategy for combined operations post-deal
2. Realistic identification of synergies between the buyer and target organization
3. Effective operational integration in a timely manner
4. Effective cultural integration in a timely manner

5. Clear leadership throughout the M&A process and following the transaction

In order to derive the most value from an M&A transaction, the parties involved should have clear strategies post-deal that take into account the elements above. M&A practitioners need to be aware of the many options available to them when considering integration, employee retention and business continuity. Some common areas of risk to the success of M&A transactions, and potential strategies to deal with these risks are discussed in more detail in the full report.
Acknowledgements

I would like to thank the following people for their support during my MBA and this project. Their guidance and encouragement has been extremely valuable and is greatly appreciated.

In particular, I would like to thank Michael Parent, whose direct approach to problem solving has always been refreshing and valuable, Elicia Maine for her ongoing support and practical words of wisdom, Alan Duncan for planting the seed that grew into my interest in accounting and Ian Hand, for introducing me to the creative world of finance.

Special thanks to Melissa McCrae, my most trusted advisor, who has “been there” to support every decision I’ve made along the way. Thanks also to my parents, John and Susan Wade, who have consistently encouraged me in all of my endeavors. A special thanks goes to my mother, Susan who has worked diligently as my proofreader.

Finally, thanks to the 2009 MOT MBA cohort, a group of people with whom I’ve spent so much time over the last two years. The support network we have created is something I’ll value for the rest of my days.
# Table of Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Approval</td>
<td>ii</td>
</tr>
<tr>
<td>Abstract</td>
<td>iii</td>
</tr>
<tr>
<td>Executive Summary</td>
<td>iv</td>
</tr>
<tr>
<td>Acknowledgements</td>
<td>vii</td>
</tr>
<tr>
<td>Table of Contents</td>
<td>viii</td>
</tr>
<tr>
<td>List of Charts &amp; Tables</td>
<td>x</td>
</tr>
<tr>
<td>1: Introduction</td>
<td>1</td>
</tr>
<tr>
<td>2: Mergers and Acquisitions Background</td>
<td>3</td>
</tr>
<tr>
<td>2.1 Types of M&amp;A Activity</td>
<td>3</td>
</tr>
<tr>
<td>2.2 Historic M&amp;A Cycles</td>
<td>6</td>
</tr>
<tr>
<td>2.3 Factors contributing to M&amp;A Activity</td>
<td>7</td>
</tr>
<tr>
<td>3: Market</td>
<td>10</td>
</tr>
<tr>
<td>3.1 Global</td>
<td>11</td>
</tr>
<tr>
<td>3.2 The Americas</td>
<td>15</td>
</tr>
<tr>
<td>3.2.1 The United States</td>
<td>16</td>
</tr>
<tr>
<td>3.2.2 Canada</td>
<td>19</td>
</tr>
<tr>
<td>4: Buyer vs. Seller Perspectives</td>
<td>24</td>
</tr>
<tr>
<td>4.1 Buyers</td>
<td>24</td>
</tr>
<tr>
<td>4.1.1 Strategic Buyers</td>
<td>24</td>
</tr>
<tr>
<td>4.1.2 Financial Buyers (Leveraged Buy Out - LBO)</td>
<td>25</td>
</tr>
<tr>
<td>4.1.3 Strategic / Financial Buyers (LBO)</td>
<td>26</td>
</tr>
<tr>
<td>4.2 Sellers</td>
<td>30</td>
</tr>
<tr>
<td>4.2.1 Distressed companies</td>
<td>31</td>
</tr>
<tr>
<td>4.2.2 Public Mid-Cap</td>
<td>33</td>
</tr>
<tr>
<td>4.2.3 Family Owned</td>
<td>34</td>
</tr>
<tr>
<td>5: Valuation Trends</td>
<td>35</td>
</tr>
<tr>
<td>5.1 External Issues Affecting Value</td>
<td>35</td>
</tr>
<tr>
<td>5.1.1 Economic Factors</td>
<td>36</td>
</tr>
<tr>
<td>5.1.2 Industry &amp; Market Positioning</td>
<td>37</td>
</tr>
<tr>
<td>5.1.3 Geography</td>
<td>38</td>
</tr>
<tr>
<td>5.1.4 Precedent Transactions</td>
<td>40</td>
</tr>
<tr>
<td>5.2 Internal Factors Affecting Value</td>
<td>41</td>
</tr>
<tr>
<td>6: Financing Methods &amp; Trends</td>
<td>43</td>
</tr>
<tr>
<td>6.1 Cash</td>
<td>43</td>
</tr>
<tr>
<td>6.2 Debt</td>
<td>46</td>
</tr>
</tbody>
</table>
6.3 Senior Debt.................................................................................................................48
6.4 Subordinate or Junior Debt........................................................................................48
6.5 Asset Based Loan.........................................................................................................49
6.6 Mezzanine Debt..........................................................................................................50
6.7 Bridge Loan................................................................................................................51
6.8 Equity .........................................................................................................................51
6.8.1 Spreading the Financial Risk & Partnerships.........................................................52
6.8.2 Business Continuity and Equity Ownership .........................................................52
6.9 Earn out incentives ....................................................................................................54
6.10 Holdbacks..................................................................................................................54
6.11 Combined Acquisition Loans ....................................................................................55

7: M&A Success Factors ..................................................................................................56

8: Issues Affecting the Deal Pre-closure .........................................................................57
8.1 Disclosure & Misrepresentation of Information.........................................................59
8.2 Pending Legal, Regulatory, and Environmental Issues...........................................60

9: Issues that Affect Value Post-deal ...............................................................................61
9.1 Change Management .................................................................................................61
9.2 Culture & Conflict .....................................................................................................69

10: Strategies to Mitigate Risks .......................................................................................71
10.1 Disclosure and Due Diligence ..................................................................................71
10.2 Deal Protection ..........................................................................................................72
10.3 Realistic Estimation of Value Creation ....................................................................73
10.4 Have a Plan ...............................................................................................................74
10.5 Integration ................................................................................................................74
10.6 Human resources .....................................................................................................78
10.7 Incentives ..................................................................................................................80
10.8 Consider Your Alternatives: M&A is one of many options .....................................81

11: Conclusions and Recommendations .........................................................................83

12: Appendix A – M&A Global Trends by Activity Type 2007-2010 ..............................86
13: Appendix B – Deal Multiples in North America 2010 ...............................................87
14: Works Cited .................................................................................................................88
List of Charts & Tables

Figure 1 - Global Mergers and Acquisitions Deal Types Q1 comparison 2007-2011 (Allen & Overy, 2011) .................................................................................................................. 11

Table 1 – Mergers and Acquisition Deals by Region Q1 2011 (Bloomberg, 2011) .............................................................. 12
Figure 2 – Expected distribution of 2011 M&A buyers and targets by region (Bloomberg, 2011) ............................................. 13
Figure 3 - Expected global targets by type in 2011 (Bloomberg, 2011) ............................................................................. 14
Figure 4 – Monthly M&A trends in the Americas 2009-2010 (Bloomberg, 2011) ................................................................. 15
Figure 5 – Number of Announced and Closed M&A transactions in the U.S. 2006-Q1 2011 (Capital IQ, 2011) ......................... 16
Figure 6 - Announced and Closed M&A transactions in the U.S. Q1 2006 - Q1 2011 by overall transaction value (Capital IQ, 2011) .......................................................................................... 17
Figure 7 – Expected breakdown of top targets by U.S. buyers by region in 2011 (Bloomberg, 2011) ......................................... 18
Figure 8 – Canadian M&A Announcements by quarter 2006-2010 (Blakes Canadian Lawyers, 2011) .............................. 19
Figure 9 – Canadian M&A 2010/2011 by industry (Blakes Canadian Lawyers, 2011) ........................................................... 20
Figure10 – Canadian M&A 2010/2011 by transaction size (Blakes Canadian Lawyers, 2011) .............................................. 21
Figure11 – Canadian cross-border M&A transactions 2009 and 2010 (Blakes Canadian Lawyers, 2011) ........................... 22

Figure 12 – Comparison of Strategic and Financial (LBO) buyers in Canada who have successfully completed M&A transactions 2007-2011 .................................................................................. 27
Figure 13 – Comparison of Strategic and Financial (LBO) buyers in the U.S. who have successfully completed M&A transactions 2007-2011 ........................................................................ 29
Figure 14 – Bloomberg CEO survey of most likely M&A target types in 2011 (Bloomberg, 2011) ......................................... 31
Figure 15 – NASDAQ market performance 2005-2011 ........................................................................................................... 36
Figure 16 – U.S. M&A transaction multiples in the IT industry 2007-2011 .......................................................... 37
Table 2 - Closed M&A Transactions multiples Implied EV / EBITDA in the U.S. 2007-2011 (Capital IQ, 2011) .................... 39
Table 3 - Closed M&A Transactions multiples Implied EV / EBITDA in Canada 2007-2011 (Capital IQ, 2011) .................. 39
Table 4 – Advantages and disadvantages of precedent transaction analysis ........................................................................ 40
Figure 17 – CEO survey responses on major sources of deal financing in 2011 ............................................................. 43
Figure 18 – United States Federal Funds Interest Rate 1954 – 2009 .................................................................................. 45
Figure 19 – Transactions in the U.S. involving only cash 2008 – 2010 (Bloomberg, 2011) ................................................. 45
Table 5 – Example of returns on leveraged transactions .............................................................................................. 47
Figure 20 – Types of debt, risk and reward from the lender’s perspective _______________________________________________47
Figure 19 - Gross Equity Offerings in North America 2006 – 2011 (Capital IQ, 2011) ____________________53
Table 6 – Examples of deal financing structure ________________________________________________________________55
Figure 20 – Canadian M&A deal cancelations 2008 – 2010 (Capital IQ, 2011) ___________________________57
Figure 21 – U.S. M&A deal cancelations 2008 – 2010 (Capital IQ, 2011) ________________________________58
Figure 22 – M&A related lawsuits in the U.S. 2008 – 2010 (Capital IQ, 2011) ____________________________60
Table 7 – Breakdown of industries, targets and executives included in Krug’s executive churn survey
(Shill, 2008) _________________________________________________________________62
Figure 23 – A comparison of executive turnover between companies that have and had not experienced
a merger (Shill, 2008) ____________________________________________________________63
Figure 24 – A comparison of executive turnover between companies that have experienced one M&A
transaction and those who have not experienced M&A (Shill, 2008) ____________________________64
Figure 25 – A comparison of executive turnover between companies that have experienced multiple
M&A transactions and those who have not experienced M&A (Shill, 2008) ____________________________65
Figure 26 – A comparison of executive turnover between companies that have experienced multiple
M&A transactions in the 1980s, 1990s and 2000s with those who have not experienced M&A (Shill,
2008) _________________________________________________________________67
Figure 26 – Business integration characteristics ___________________________________________________________76
Figure 27 – Guide to partnership vs integration (Prashant Kale, 2009) ______________________________________77
Figure 28 – M&A alternatives flow chart (Mitchell, 2010) ________________________________________________82
1: Introduction

Mergers and acquisitions (M&A) are the buying, selling and strategic combination of two or more companies to create or facilitate rapid growth in shareholder value. M&A usually take place where it is more advantageous for buyers to purchase an existing organization than to build a completely new company, product or capability. A key driver for M&A activity is the creation of increased value from the combination of companies that would be difficult to realize should each organization continue to operate as a separate unrelated entity.

At the broad strategic level there are two areas in which M&A practitioners seek to add value:

   a) Reducing operational costs through the creation of economies of scale as a company becomes larger.

   b) Increasing revenues through the introduction of new markets, products or services.
While the potential for synergies, cost savings, and new revenue opportunities between two businesses can be fairly easily identified on paper, they are much harder to execute successfully in reality. M&A are a complex and difficult game where only a small percentage of players achieve success. The failure rate of attempted mergers and acquisitions is estimated at somewhere between 70% and 90%, which includes M&A that fail to generate expected value, and M&A transactions that actually reduce the value of the companies involved (Christensen, 2011).

This report looks at the current state of M&A with a focus on North America. This report also looks into M&A activity in more depth in a select group of industries. It will look at the hazards of M&A and suggest ways to mitigate the risks of M&A failure to create value, as well as strategies to increase the chances of success.
2: Mergers and Acquisitions Background

M&A is not a new concept. This fact is well illustrated by a brief look at M&A activity cycles in the history of Western business.

2.1 Types of M&A Activity

M&A is a broad term that encompasses a number of different financial and organizational transactions. It is important to understand these activities before discussing M&A further.

**Take Private** – A Take Private transaction is one where a public company makes the decision to become a privately held business. Private equity groups, company founders and directors usually initiate this type of transaction. Their justification for this type of transaction is that they can run the company more efficiently without having to seek shareholder approval for their decisions. Take Private transactions are sometimes referred to as Leveraged Buyouts (LBO). LBO transactions use debt to finance the acquisition leaving the company burdened by future debt payments.

**Public recommended acquisition** – A recommended acquisition occurs in a public company where the board and management agree to the purchase of another business
**Public Hostile acquisition** – A hostile acquisition or hostile takeover occurs when a public company's board and management is unwilling to sell the company. Despite this, another company pursues the sale through the purchase of shares. As the acquiring company gains more shares, their ability to influence decisions increases. When the acquiring company owns a certain percentage of shares, they have the ability to remove the board and replace it with one that favors the sale of the business.

**Private M&A** – A private acquisition is one where one privately held business buys another privately held business.

**Merger** – A merger is conceptually different from an acquisition. In the case of an acquisition, one company acquires another. This implies that the acquiring company has control over both businesses. A merger is different, and implies that the two companies involved in the transaction have joint control of the resulting combined organization.

**Joint Venture** – A joint venture occurs when two or more businesses agree to develop an opportunity together and share the subsequent costs and revenues. Joint ventures can be limited in scope. There can also be limits on the length of time allowed for development of the opportunity before re-negotiation needs to occur.
**Asset / subsidiary disposal** – A transaction of this nature is usually referred to as a carve-out. Carve-outs occur when an asset or subsidiary no longer fits the strategy of the company as a whole. This could occur where a subsidiary is in a different line of business, is underperforming, or when the parent company needs to dispose of assets to generate cash. Carve-outs will most commonly involve selling the asset to a third party.

**Demerger** – a demerger is a form of restructuring where a company is separated into multiple independent organizations. It is the opposite of a merger and is often referred to as a Spin-off, where a new independent company is spun out of an existing business. Spin-offs are usually a result of a particular business unit having value, but not fitting into the whole organization’s corporate strategy. Rather than having fragmented business units, the decision is made to separate them. A demerged company can still be owned by the same parent company, it just operates independently.

More information on the global M&A activity type trends from 2007 to 2010 can be found in Appendix A.
2.2 Historic M&A Cycles

1897-1904

A drive for commercial efficiencies and westward migration across the U.S. and Canada created an M&A boom in metals, transportation and mining. This period ended suddenly in 1904 with a stock market crash largely fueled by fraudulent financing.

1916-1929

World War I created an industrial boom in the Western world, which continued into the post war period. This period of M&A prosperity was brought to an end with the 1929 stock market crash.

1965 – 1969

The rising stock market created an economic boom particularly in engineering and in the creation of large conglomerate companies. As companies demanded higher and higher asking prices the market could no longer sustain their growth. Excessive leverage also made companies unable to continue making acquisitions due to heavy debt loads.

1981 – 1989

The underperformance of U.S. conglomerates fueled a series of large corporate break-ups. A favorable regulatory environment and a weak U.S. dollar attracted foreign buyers and hostile takeovers. This period ended with a series of very public bankruptcies and the 1990 recession.
1992 – 2000

This period is often referred to as the “Internet Boom” with a massive increase in stock market activity around e-commerce and technology. Historically, this is also the period of highest M&A activity in terms of valuations and number of transactions. This period ended when the Internet bubble burst, sending stock prices crashing during 2001 and 2002.

2003 – 2007

Low global interest rates and rising stock markets, combined with the globalization of businesses and high commodity prices, fueled a lot of cross border transactions. The period ended with an economic slowdown and the U.S. financial crisis. The U.S. was the first of many industrial nations to experience financial distress at this time. (DePamphilis, 2011).

2.3 Factors contributing to M&A Activity

M&A activity is very dependent on a variety of economic factors, all of which are evident in the historical analyses outlined in the previous section. At a high level, these factors include:

- Readily available credit
- Low interest rates
- Rising equity markets
- Changes in technology
• Industry consolidation or the breakup of previously consolidated organizations

• Increased globalization of business (DePamphilis, 2011)

The global economic crisis in 2008-2009 brought M&A activity around the world to a halt, as moneylenders decreased their appetite for risk, and low interest financing dried up. In 2010, industries began to recover from the recession to create a very M&A friendly market for organizations looking to increase their value in 2011.

A consideration of the factors that contribute to increased M&A activity (listed above) suggests that 2011 and 2012 is likely to be the next period of M&A boom. Moneylenders are beginning to become more adventurous with their capital. Global interest rates are low, and businesses have been holding back on potential transactions until the economy recovers, so that better asking prices can be sought. These conditions should cause a significant increase in the number of M&A transactions in 2010-2012. (Capital IQ, 2011)
An additional and very significant factor contributing to M&A in the coming years is that the baby boomer generation will be exiting privately held businesses. In the U.S. alone, it is estimated that 8000-10,000 baby boomers will retire each day for the next ten years (Taylor, 2010). This is estimated to equate to 8 million privately held companies changing hands during that period. Unlike previous generations who have been subject to family succession planning, the next generation has shown significantly less interest in continuing to own family businesses. This change is expected to create a dramatic increase in the number of companies for sale.
3: Market

M&A transactions contain two essential elements: (a) a price, and (b) the terms that structure the deal. Each transaction is a complex negotiation where the seller tries to get the maximum price and the most favorable terms possible, while the buyer tries to get maximum value for minimum cost and favorable terms.

When an organization considers an M&A transaction, there are analyses that can be done in order to better understand the current market. However, it is difficult to accurately predict the outcome of specific transactions due to the variations and complexities of different environments and industries. Examples of variations which impact the value and structure of an M&A transaction include the popularity of a given industry and the economic climate at the time of the deal (Miler, 2008). Additional complexities could include accounting for intangible assets and the impact of emotional issues on the part of either party.

With these uncertainties in mind, the M&A industry is closely monitored by interested parties to determine trends that may influence future transactions. While this is more of an art than a science, such trends give an overview of the factors that might influence an upcoming M&A transaction.

The following sections discuss these trends, first globally, and then in the North American, American, and Canadian contexts.
3.1 Global

On a global scale, investors are beginning to return to the market to look at M&A investments after the market slowdown of 2008 and 2009. Figure 1 below, shows evidence of a trend toward increased transaction activity during 2010 and 2011.

Global deal types

![Graph showing global mergers and acquisitions deal types Q1 comparison 2007-2011](image)

*Figure 1 - Global Mergers and Acquisitions Deal Types Q1 comparison 2007-2011 (Allen & Overy, 2011)*

As seen in Figure 1, M&A activity declined significantly in 2009 but has begun to recover in 2010 and 2011. A detailed breakdown of global deals over the last five years can be found in Appendix A. This breakdown shows not only that global deal volume is on the rise in the first quarter of 2011, but also that the overall deal value has risen twenty five percent over Q1 2010.
Areas of increased activity include Brazil, an emerging economy that is experiencing a 10-year high in M&A transactions. India has also seen immense growth with a 189% increase in transaction value from Q1 2010, to Q1 2011 (Bloomberg, 2011). The current distribution of M&A is shown in Table 1.

**Global M&A Transactions Q1 2011**

<table>
<thead>
<tr>
<th>Region</th>
<th>Number of deals Q1 2011</th>
<th>Value of deals Q1 2011 (Millions $ U.S.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia Pacific</td>
<td>115</td>
<td>1,540,680</td>
</tr>
<tr>
<td>Central and Eastern Europe</td>
<td>21</td>
<td>380,289</td>
</tr>
<tr>
<td>India</td>
<td>10</td>
<td>135,755</td>
</tr>
<tr>
<td>Latin America</td>
<td>32</td>
<td>417,444</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>7</td>
<td>109,849</td>
</tr>
<tr>
<td>United States</td>
<td>171</td>
<td>3,582,159</td>
</tr>
<tr>
<td>Western Europe</td>
<td>123</td>
<td>3,218,957</td>
</tr>
</tbody>
</table>

*Table 1 – Mergers and Acquisition Deals by Region Q1 2011 (Bloomberg, 2011)*
Cross border transactions worldwide are expected to increase in 2011 and 2012 with Asia Pacific buyers becoming increasingly active in the global market. As has been the case for the past few years, it’s expected that North American companies will continue to be the leading acquisition targets throughout the next 12-24 months, narrowly beating Asian Pacific target companies as depicted in figure 2.

**Expected Global M&A Buyers and Sellers in 2011**

![Diagram showing expected distribution of M&A buyers and targets by region.](image)

*Figure 2 – Expected distribution of 2011 M&A buyers and targets by region (Bloomberg, 2011)*
A global survey of CEO’s considering an M&A transaction following the global recession of 2008 showed overwhelmingly that the majority of M&A transactions globally would target distressed businesses that are barely surviving through lack of access to capital and resources to build their businesses (Bloomberg, 2011).

**Expected Global M&A Sellers in 2011**

*Figure 3 - Expected global targets by type in 2011 (Bloomberg, 2011)*
3.2 The Americas

The Americas (the United States and Canada) announced over $1.1 trillion in M&A transactions during 2010, which was a 12% increase over 2009. The average deal size in the region for that period was $264 million with buyers paying an average of 9.3x EBITDA for publicly traded targets. Over 70% of deals were paid either in cash or in a mixture of cash and stock. (Bloomberg, 2011).

For a more detailed analysis of target multiples in the Americas please refer to Appendix B.

Figure 4 – Monthly M&A trends in the Americas 2009-2010 (Bloomberg, 2011)
3.2.1 The United States

Like other countries around the globe, the U.S. is predicted to steadily increase M&A activity during 2011 and 2012. As the economy has recovered from the economic downturn of 2008, there has been a corresponding increase in the number of M&A transactions in the U.S.

M&A Transactions in the U.S. Q1 2006 – Q1 2011 by Number of Transactions

*Figure 5 – Number of Announced and Closed M&A transactions in the U.S. 2006-Q1 2011 (Capital IQ, 2011)*
Despite a growing number of transactions since the beginning of 2009 shown in figure 5, the overall value of the M&A market has not yet increased. As shown in figure 6, the overall dollar value of transactions increased from 2009 to 2010, but at a slower pace than the increased number of transactions shown in figure 5 might suggest. This data confirms that company valuations are still recovering, and that there is churn in the market where distressed businesses or those unable to wait for valuations to recover are selling out.

M&A Transactions in the U.S. Q1 2006 – Q1 2011 by Overall Transaction Value

Figure 6 - Announced and Closed M&A transactions in the U.S. Q1 2006 - Q1 2011 by overall transaction value (Capital IQ, 2011)
The United States (U.S.) has been the global M&A market leader for many years, typically making up 40% of global transactions by volume. This trend appears to be set to continue through 2011 (Allen & Overy, 2011). Much of this volume will include cross border transactions. Of particular note is an increase in the number of active Asian investors looking to acquire U.S. businesses. This is good news for U.S. businesses looking to increase their asking price but potentially bad news for domestic bidders.

As depicted in Figure 7, U.S. businesses will mainly target their domestic market. Approximately 70% of transactions will be U.S. businesses buying U.S. targets, with the remaining 30% U.S. businesses making foreign acquisitions. Notably, US buyers are expected to target industries such as energy, mining, technology and telecommunications with the bulk of investment dollars.

![Top Target Countries by Volume](image)

*Figure 7 – Expected breakdown of top targets by U.S. buyers by region in 2011 (Bloomberg, 2011)*
3.2.2 Canada

Canadian M&A activity has experienced the same trends seen in the U.S. following the financial crisis of 2008. A sharp decline in deals occurred in Q4 2007, however the market has shown a fairly steady increase in both size and value since Q1 2009. Of particular interest is the split between mid-large capital value transactions ($5 million to < $1 billion) and mega deals (> $1 billion). As shown in figure 8 and in corresponding literature reviews (American Bar Association Business Law Section, 2010), the value and volume of mega deals has seen the greatest decline following 2008, while smaller deals have continued to experience a fairly active market throughout the recession.

Figure 8 – Canadian M&A Announcements by quarter 2006-2010 (Blakes Canadian Lawyers, 2011)
The transaction data can be further broken down by industry to identify the sectors that are experiencing the most activity. There was an increase in the number of M&A deals being done in Canada from 2009 to 2010 in almost all industry sectors. Mining continued to lead the pack with 40% of transactions by dollar value.

**Canadian M&A by Industry 2010/2011**

![Pie chart showing industry distribution of M&A transactions](image)

*Figure 9 – Canadian M&A 2010/2011 by industry (Blakes Canadian Lawyers, 2011)*
At the same time there was a trend away from large capital value deals occurring in Canada. More than half of the transactions in 2010 were less than US$250 million, and 92% were less than US$1 Billion. As shown in figure 10, the number of smaller transactions has been increasing significantly over the past three years.

**Canadian M&A Breakdown by Transaction Size 2010/2011**

*Figure 10 – Canadian M&A 2010/2011 by transaction size (Blakes Canadian Lawyers, 2011)*

Foreign investment in Canadian businesses continues to be on the rise. In particular, an increase in the number of Asian investors buying Canadian businesses has been evident over the last 12 months and this trend is expected to continue (Houlihan Lokey, 2010). Canadian commodities and agricultural assets are seen as strategic assets for countries who do not have natural deposits or available farmland.
Historically, Canadian businesses have acquired foreign companies at a rate of two foreign companies for every one Canadian company bought by a foreign company. Due to the increased value of the Canadian dollar against the U.S. dollar, Canadian outbound transactions have increased to approximately 3.5X of inbound acquisitions. The purchase of U.S. businesses by Canadian businesses currently accounts for in more than 80% of outbound cross border M&A investments. (Blakes Canadian Lawyers, 2011)

**Canadian Cross-Border Transaction 2009 and 2010**

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th></th>
<th>2009</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td># of Deals</td>
<td>Value $Millions</td>
<td># of Deals</td>
<td>Value $Millions</td>
</tr>
<tr>
<td><strong>Canadians Acquiring</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign Companies</td>
<td>326</td>
<td>64,171</td>
<td>212</td>
<td>33,065</td>
</tr>
<tr>
<td>Cdn Co's from Foreigners</td>
<td>21</td>
<td>8,439</td>
<td>22</td>
<td>2,795</td>
</tr>
<tr>
<td>Total</td>
<td>347</td>
<td>72,610</td>
<td>234</td>
<td>35,860</td>
</tr>
<tr>
<td><strong>Top Foreign Target Country of Canadian Acquirors</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td>166</td>
<td>31,365</td>
<td>104</td>
<td>9,279</td>
</tr>
<tr>
<td><strong>Foreigners Acquiring</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canadian Companies</td>
<td>113</td>
<td>25,994</td>
<td>84</td>
<td>28,670</td>
</tr>
<tr>
<td>Foreign Co's from Cdn</td>
<td>44</td>
<td>6,501</td>
<td>47</td>
<td>5,792</td>
</tr>
<tr>
<td>Total</td>
<td>157</td>
<td>32,495</td>
<td>131</td>
<td>34,462</td>
</tr>
<tr>
<td><strong>Top Foreign Acquiror of Canadian Located Companies</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td>61</td>
<td>9,680</td>
<td>49</td>
<td>5,595</td>
</tr>
</tbody>
</table>

*Figure11 – Canadian cross-border M&A transactions 2009 and 2010 (Blakes Canadian Lawyers, 2011)*
Changes to the way deals are financed have also been seen over the past three years. This likely reflects the fluctuating cost and availability of capital. In 2007/2008, 64% of transactions were cash only (American Bar Association Business Law Section, 2010). The number of cash deals has declined steadily since that time. Deal structures have become increasingly diverse since the U.S. financial crisis in 2008, and often include more stock and debt than equity, given the relatively lower cost of debt. In 2010/2011 the cost of debt is quite low, so it is likely that Canadian transactions will increasingly use debt moving forward.
4: Buyer vs. Seller Perspectives

In every transaction both the seller and the buyer must agree on the “right price” at which the sale makes sense. This price will usually include a dollar figure or an exchange of shares, and also the terms each party is willing to accept in order to pursue the deal. Factors that can have a heavy influence on the negotiation are: (a) the type of buyer, and (b) the situation that has brought the seller to the negotiation table.

4.1 Buyers

Groups or individuals acquiring companies have a variety of reasons for wanting to buy. There are three broad categories of buyer: strategic buyers, financial buyers, and strategic/financial buyers, as discussed below.

4.1.1 Strategic Buyers

Strategic buyers are usually companies in a similar line of business to their targets. They may be currently operating in a different market, or can see an opportunity to sell an existing product made by the target to their own customers, or make a product and sell it to the target’s existing customers. Most commonly, strategic buyers are large companies with significant financial capacity. Typically, strategic buyers can see the value of combining their own existing companies with the target business and so are willing to pay more than a financial buyer (see section 4.1.2)
might be prepared to offer. Often, a strategic buyer will not have a planned exit strategy from the business. The buyer is not interested in selling the company in the foreseeable future.

Competitors who are operating in the same market with the same products are not considered to be strategic buyers. They are simply competitors seeking to buy market share. This is not considered an effective M&A strategy as the acquiring company is not generating any new value.

4.1.2 Financial Buyers (Leveraged Buy Out - LBO)

Financial buyers are those who are looking to make acquisitions, quickly increase the value of a newly acquired business and then exit. These buyers are usually entrepreneurial individuals who have a clear exit strategy in place before acquiring the business, usually in a sale or public offering. On occasion this type of buyer has been given a bad reputation by those attempting highly publicized hostile takeover bids.

Financial buyers are experts in raising investment capital. However, they are often limited financially to capital they can access through debt, from investors, and from leveraging assets at the target company. For this reason, financial buyers have a reputation for offering lower prices than strategic buyers.
4.1.3 Strategic / Financial Buyers (LBO)

This is a group of buyers who operate both as strategic and as financial buyers. That is, they make acquisitions for strategic reasons, but also have a clear exit strategy in place. Examples of buyers in this group include private equity groups who wish to add on to an existing business with new markets or products, but who will ultimately exit at the end of the life of the investment fund. Strategic/Financial buyers are a not as predominant as the other two buyer types.

Figure 12 depicts the distribution of financial and strategic buyers, headquartered in Canada, which completed transactions during the period from 2007 to 2011. The data shows that the fluctuation in the number of strategic buyer transactions over time is much greater than the fluctuation in the number of financial buyer transaction during the same time period. The number of financial buyers ranges between 3% and 9% of the number of strategic buyers for that period.

The number of strategic transactions varies greatly from year to year and appears to have followed, or to have been influenced by the downturn in the economy in 2008. As the economy recovers, the number of strategic transactions increases significantly, while the number of financial transactions remains fairly steady at 25-50 a quarter. From this data, it appears that Canadian financial buyers are less sensitive to economic downturns than their strategic counterparts.
Canadian Financial (LBO) and Strategic Buyers 2007-2011

Figure 12 – Comparison of Strategic and Financial (LBO) buyers in Canada who have successfully completed M&A transactions 2007-2011

Figure 13 depicts the distribution of financial and strategic buyers headquartered in the United States completing transactions from 2007 to 2011. The data is surprisingly similar to the Canadian data previously discussed and reinforces the suggested conclusion across geographies.
During the period 2007-2011, the fluctuation in the number of strategic buyers is much greater than the fluctuation in the number of financial buyer transactions. Financial buyers represent between 7% and 14% of the number of strategic buyers. While the number of strategic transactions varies greatly, and appears be influenced by the downturn in the economy in 2008, financial transactions appear to be relatively steady. As the economy recovers, the number of strategic transactions increases dramatically while the number of financial transactions remains consistent at 250-400 a quarter.
Figure 13 – Comparison of Strategic and Financial (LBO) buyers in the U.S. who have successfully completed M&A transactions 2007-2011
The bulk of financial buyers in North America are private equity funds (PE) that generally hold investors’ funds for a period of 10 years. They typically must invest this capital in the first few years of that period to ensure a return in the 10 year time frame. For funds raised in 2006 and 2007 that are not yet invested, there is a short period left to put those funds to work as they are in years 5 and 6 of their investment period.

According to a survey of PE fund managers, 2009 was a cautious year for investments after the 2008 recession. Because of this caution, 80% of fund managers still need to invest 25% or more of their current fund, and 27% still need to invest 75% or more (Shim, 2010). In other words, there is a significant backlog of funds needing to be invested in the near term. Much of this investment will involve financial acquisitions. Over the next 4-6 years PE groups will therefore be a significant source of financing for M&A transactions.

### 4.2 Sellers

The decision for a business owner to sell can be triggered by any number of economic or qualitative factors. As these factors can potentially have a significant impact on the progress of negotiations and the eventual sale price it is important to understand the motivation behind the sale wherever possible. For example; a sale motivated by retirement may have a very different timeline and valuation from the same business divesting a division due to a change in strategy.
Bloomberg published a survey of the opinions of North American CEO’s who aimed to predict which businesses would be the most popular M&A targets in 2011. Respondents were able to select several types of businesses that they felt would make the most likely targets. As shown in figure 14, the three leading candidates for M&A were: Distressed companies, Public Mid-Cap companies, and Family Owned businesses.

![Bar Chart](image)

*Figure 14 – Bloomberg CEO survey of most likely M&A target types in 2011 (Bloomberg, 2011)*

### 4.2.1 Distressed companies

Distressed companies are a growing sector in M&A transactions. The cause of distress can range from the state of the economy generally, to poor management, to changing markets or the introduction of new regulations that make compliance too difficult or expensive. There are two basic tests to determine if a company is distressed:
**Cash Flow Test** - A distressed company is one that is unable to pay its debts as they fall due.

**Balance Sheet Test** – the Company’s assets are worth less than their liabilities.

M&A of distressed companies has increased in many North American industries. In 2005, it was estimated that these kinds of acquisitions accounted for 5% of M&A, as compared to 34% in 2010 (Birch, 2010). In strong economic times, companies in this situation would have had some chance of securing additional investment or financing, however as the availability of investors and debt dried up during the recession in 2008, companies in the same situation were left to fight for scarce investment dollars, sell themselves, or fail. A distressed business is motivated to be merged or acquired in order to avoid bankruptcy. In the first three quarters of 2010 in the U.S., over 43,000 companies filed for bankruptcy. This is a good indicator of how big the market for distressed companies is likely to be in 2011 and beyond (American Bankruptcy Institute, 2010).

If a buyer is knowledgeable about the target's operations it is possible to break the target apart with only sections of the target company being integrated into the buyer’s organization. The less desirable parts can then either be sold off or abandoned. However, despite potential bargains in the market, buyers should handle distressed companies with extreme care, as there may be many hidden reasons for their distress.
4.2.2 Public Mid-Cap

Public midcap companies are defined by the company’s level of market capitalization. While there is some variation in the definition of midcap, this report refers to midcap companies as those with a market capitalization of $2-$10 Billion. Due to the nature of a publicly held company, it will usually be a more difficult target to acquire because a buyer will potentially be negotiating with numerous shareholders instead of with a single owner.

In some cases, the CEO and company board have the power to authorize a merger or acquisition, however it is often the case that they are unwilling to do so. Human resources changes are inevitable in an M&A situation, so the CEO or board will potentially be risking the loss of their own jobs by authorizing such a transaction. Despite a fiduciary responsibility to consider offers, there are many historic examples where boards have been torn between their responsibilities and their own self-interest.

Despite the difficulties in buying a public company, it is often an attractive option for a public company to divest a division that is underperforming. Divesting is also an attractive option where a division no longer fits into the larger corporate strategy. Rather than having to let that division slowly die, selling it off is often an attractive way for a public company to raise capital in order to execute future strategic projects without creating additional corporate debt.
4.2.3 Family Owned

Family owned businesses are set to represent a significant number of future M&A transactions. In North America the baby-boomer generation is drawing close to retirement with an estimated 78 million retirements predicted in the next 10 years in the United States alone (Taylor, 2010). It is estimated that over eight million family owned businesses will change hands in the U.S. over the next 10-15 years (Lincon Benefit, 2011).

Family owned businesses make complex targets. These businesses are characteristically small to medium in size and have been run by the owner for many years. In most cases there is a lack of succession planning with younger generations either unwilling or unqualified to continue running them. The capital tied up in the business can represent the business owner’s retirement nest egg and hence their need to exit at a good price.

Emotional issues are inevitable when a family is selling a company that represents years of personal or family history. Families frequently struggle to find the right buyer, and often prefer to sell to someone they know, rather than to a stranger. This is an opportunity for strategic buyers to look within their existing network of business contacts for a potential strategic acquisition. Due to the looming retirement of the baby boomer generation, it is predicted that there will be a strong supply of family owned business on the market for the foreseeable future that is also likely to drive asking prices down. This makes it a great time to be a strategic buyer.
5: Valuation Trends

A company's valuation is an assessment of how much it is worth. The assessment of worth varies greatly however, depending on present and future circumstances, and on the nature of the buyer or buyers. While there are a number of widely accepted techniques and metrics that can be used to value a company, this process is still regarded as an art rather than a science.

5.1 External Issues Affecting Value

As has been discussed previously, the value of a business will fluctuate depending on a number of qualitative and quantitative factors. Adding to the complexity of a valuation, the type of buyer interested in the business can also affect the value of the deal. Strategic and financial buyers each bring a different perspective to how the business should be run post transaction and thus place a different value on the business in question.
5.1.1 Economic Factors

The economy has a significant effect on company valuations. In times of economic downturn, investors become more wary and the number of businesses wishing to exit the market by selling is greater than the number of potential buyers. Valuations therefore decrease. In an economic upswing, the situation is reversed, with supply decreasing while demand increases. As a result, valuations increase. To demonstrate the effect of the economy on valuations we can compare the NASDAQ market performance to IT M&A valuations in the U.S. during the 2008 recession in figures 15 and 16. A comparison of this data demonstrates a strong correlation between the two. As the NASDAQ falls so do the valuations put on IT companies: as it rises, valuations increase.

![NASDAQ Market Performance](image)

*Figure 15 – NASDAQ market performance 2005-2011*
5.1.2 Industry & Market Positioning

Valuations also fluctuate due to industry and market positioning. At any given time businesses in particular industries will be more or less desirable. If a company is positioned in a rapidly growing industry or market, valuations increase, and vice versa. For example, Table 2 and Table 3 demonstrate clear differences in valuation, in different geographic areas, over time and in different industries.
Speculation in a particular industry is common and will dramatically increase the valuation of businesses in that sector. An example of this was the dot-com bubble of 1995-2000, where speculation on new Internet technologies and businesses caused extreme spikes in the valuation of Internet businesses. During the same period, however, valuations in other industry sectors remained relatively unaffected.

5.1.3 Geography

The location of an M&A deal has an impact on the valuation of a business. In places where markets are more active, there will generally be greater demand, driving prices upward. A comparison of closed M&A transactions in Canada and the U.S. shows that, although the markets are near neighbors, levels of activity in the two countries are quite different in all industry sectors. Because the U.S. has a more active investor market in terms of overall investment value and transaction count, U.S. individual industry multiples (EV / EBITDA) are higher than their Canadian counterparts 72% of the time (Capital IQ, 2011).
Closed M&A Transactions multiples in the U.S.

<table>
<thead>
<tr>
<th>Primary Sector</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer Discretionary</td>
<td>10.93</td>
<td>11.26</td>
<td>9.46</td>
<td>10.5</td>
<td>11.18</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>10.92</td>
<td>10.31</td>
<td>8.03</td>
<td>11.95</td>
<td>8.16</td>
</tr>
<tr>
<td>Energy</td>
<td>9.43</td>
<td>11.48</td>
<td>8.07</td>
<td>8.38</td>
<td>9.9</td>
</tr>
<tr>
<td>Financials</td>
<td>15.11</td>
<td>13.33</td>
<td>10.6</td>
<td>10.01</td>
<td>13.17</td>
</tr>
<tr>
<td>Healthcare</td>
<td>16.07</td>
<td>16.33</td>
<td>10.43</td>
<td>10.09</td>
<td>12.57</td>
</tr>
<tr>
<td>Industrials</td>
<td>8.78</td>
<td>10.43</td>
<td>9.34</td>
<td>8.11</td>
<td>7.81</td>
</tr>
<tr>
<td>Materials</td>
<td>8.66</td>
<td>8.92</td>
<td>9.97</td>
<td>8.38</td>
<td>7.28</td>
</tr>
<tr>
<td>Telecommunication Services</td>
<td>8.23</td>
<td>9.2</td>
<td>7.49</td>
<td>6.13</td>
<td>6.52</td>
</tr>
</tbody>
</table>

*Table 2 - Closed M&A Transactions multiples Implied EV / EBITDA in the U.S. 2007-2011 (Capital IQ, 2011)*

Closed M&A Transactions multiples in the U.S.

<table>
<thead>
<tr>
<th>Primary Sector</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer Discretionary</td>
<td>9.84</td>
<td>7.67</td>
<td>6.28</td>
<td>6.26</td>
<td>9.82</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>10.22</td>
<td>7.9</td>
<td>6.5</td>
<td>13.87</td>
<td>10.26</td>
</tr>
<tr>
<td>Energy</td>
<td>9.03</td>
<td>6.78</td>
<td>4.86</td>
<td>7.01</td>
<td>15.51</td>
</tr>
<tr>
<td>Financials</td>
<td>16.5</td>
<td>12.72</td>
<td>15.21</td>
<td>20.69</td>
<td>13.59</td>
</tr>
<tr>
<td>Healthcare</td>
<td>10.36</td>
<td>7.39</td>
<td>5.2</td>
<td>6.6</td>
<td>10.52</td>
</tr>
<tr>
<td>Industrials</td>
<td>7.14</td>
<td>7.88</td>
<td>7.05</td>
<td>5.18</td>
<td>6.65</td>
</tr>
<tr>
<td>Information Technology</td>
<td>10.86</td>
<td>8.5</td>
<td>9.56</td>
<td>5.8</td>
<td>12.01</td>
</tr>
<tr>
<td>Telecommunication Services</td>
<td>8.17</td>
<td>15</td>
<td>15.55</td>
<td>3.61</td>
<td>N/A</td>
</tr>
<tr>
<td>Utilities</td>
<td>16.26</td>
<td>7.47</td>
<td>7.04</td>
<td>30.32</td>
<td>22.52</td>
</tr>
</tbody>
</table>

*Table 3 - Closed M&A Transactions multiples Implied EV / EBITDA in Canada 2007-2011 (Capital IQ, 2011)*
5.1.4 Precedent Transactions

The analysis of precedent transactions of similar businesses in similar circumstances can be used to estimate a company’s value. This is a widely used method that has both advantages and disadvantages, as identified in table 4. Although table 4 outlines a number of limitations to this practice, it is widely used to evaluate future transactions.

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Insight into real transactions that have successfully closed</td>
<td>• Usually based on public company data, because private company data is mostly unavailable</td>
</tr>
<tr>
<td>• Very helpful in identifying market valuation trends</td>
<td>• Public company data can be misleading when comparing with private transactions</td>
</tr>
<tr>
<td>• Helps to assess supply and demand in specific sectors</td>
<td>• Doesn’t capture market conditions at the time of the transaction which can have a heavy influence on the valuation</td>
</tr>
<tr>
<td>• Can analyze transactions based on industry, market position, transaction characteristics, and geographic contexts</td>
<td>• Based on multiples and ratios which do not capture all aspects of the transaction</td>
</tr>
<tr>
<td></td>
<td>• Valuations can vary significantly which can make them easily manipulated</td>
</tr>
<tr>
<td></td>
<td>• It is very rare to find a directly comparable transaction</td>
</tr>
</tbody>
</table>

Table 4 – Advantages and disadvantages of precedent transaction analysis
5.2 Internal Factors Affecting Value

According to leading M&A investors there are a number of key internal elements that will make a target more attractive and hence more valuable (Shea & Company, 2011). They include:

A seasoned and committed management team – the presence of experienced professionals who have proven their ability to grow and maintain businesses. The retention of these people so that they can convey business knowledge to others is a key to success. Often M&A transactions will incentivize leadership to stay at the company for a period of time.

Attractive market share – The Company has a proven ability to develop and retain customers.

Excellent use of technology – The target company uses technology to lower operational costs, increase agility, and to differentiate the organization from its competitors.

Recurring revenues and good margins – Revenues are consistent and reliable quarter after quarter and product or service margins are also high.

Low risk of change – The impact of regulatory, technological, and market changes are minimal, or the company has the capacity to make adjustments easily and quickly.

Stable and predictable cash flows – Cash is flowing in and out of the company reliably and often.
Loyal and diversified customer base – Customers are committed to the product or service, however no single customer has the ability to significantly affect sales revenues if they choose to no longer be a customer.

Attractive growth and compelling economics – The company is experiencing rapid or steady growth in its customer base.

Strong products and defensible market positions – Products and services are well developed and differentiated from competitors. Promising future products are already in development.
6: Financing Methods & Trends

It may surprise some people that M&A deal financing can be quite a creative process. Deals are usually unique and therefore the financing methods change to fit the circumstances. This section of the report examines how deals are being financed at the present time and predicts how this might change in 2011 and 2012.

Expected Major Sources of M&A Deal Financing in 2011

![Circle diagram showing cash, equity, and debt financing sources]

Figure 17 – CEO survey responses on major sources of deal financing in 2011

6.1 Cash

Cash is self-explanatory as a form of finance for M&A activity. Acquirers who have cash on their books may choose to use it to finance a deal; however, this decision will be based on a number of factors including:
**Availability of Debt** – Are lending institutions lending money at the time? During recessions the availability of debt usually shrinks as lenders become overly cautious of new investments and the risk associated with them.

**Cost of Debt** – If the cost of debt is low then it may be in the interest of the acquiring company to hold on to its cash to fund other strategic or operational initiatives. However, if the cost of debt is high, then it may be more beneficial to use the cash accumulated on the books rather than burdening a new M&A venture with crippling debt payments.

The cost of debt to the acquiring company fluctuates with the movement of the federal funds rate, which is the rate at which banks lend one another money. Figure 18 shows the historic movement of the Federal Funds Rate 1954-2009. As is evident in figure 18, the rate changes considerably over time. These changes are passed on to the end customers who, in this case, are M&A buyers wishing to raise capital to make acquisitions.
Figure 18 – United States Federal Funds Interest Rate 1954 – 2009

As is the case with all types of deal financing, cash is usually used in conjunction with other methods. Some deals will continue to be cash only. However, as shown in figure 19, there is a declining trend in the U.S. for cash only deals.

Figure 19 – Transactions in the U.S. involving only cash 2008 – 2010 (Bloomberg, 2011)
6.2 Debt

Debt or leverage is where a bank or investor lends funds to a buyer. Debt is used as a means to finance M&A transactions in the majority of cases. In fact, with many buyers debt is essential to achieving appropriate returns, as demonstrated by the following example:

A buyer buys a business for $400 and one year later the business is worth $440. The buyer has two options to finance the purchase: cash only, or cash and debt. As outlined in table 5, the cash and debt option results in a higher return on investment. On a very small scale, this demonstrates the potential advantage of using debt to finance an acquisition.

<table>
<thead>
<tr>
<th>Option A: Cash only purchase</th>
<th>Option B: Cash and Debt purchase</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The buyer uses $400 cash</td>
<td>• The buyer uses $200 cash and $200 debt to buy the business</td>
</tr>
<tr>
<td>• The value of the business</td>
<td>• The value of the business rises and it is sold for $440 one year later</td>
</tr>
<tr>
<td>rises and it is sold for</td>
<td>• The $200 loan is repaid</td>
</tr>
<tr>
<td>$440 one year later</td>
<td>• The buyer has made a 20% return on their cash investment</td>
</tr>
<tr>
<td>• The buyer has made a 10%</td>
<td>• The buyer uses 5% of the extra 10% return on his or her cash investment</td>
</tr>
</tbody>
</table>
Table 5 – Example of returns on leveraged transactions

Thus, private equity groups who seek to increase their portfolio returns will have to utilize debt to achieve this. Their next choice is what type of debt, as debt comes in many forms, each with a different risk profile for the lender. As the risk increases, so does the return to the lender. Figure 20 depicts a variety of debt types from the perspective of the lender and their relationship with risk and reward, as seen through the lender’s eyes.

Figure 20 – Types of debt, risk and reward from the lender’s perspective
6.3 Senior Debt

Senior debt is secured debt that takes priority over all other loans. In the event of bankruptcy, senior debt must first be repaid before other creditors receive payment. As company assets usually secure this type of debt, it represents the lowest level of risk for the lender. As a result, it is the cheapest type of debt for an acquiring company to access. However, there is a limit to the quantity of senior debt that can be accessed to finance an acquisition, as there is a finite quantity of assets to secure the senior debt. In most cases, senior debt will be used in combination with other forms of financing.

6.4 Subordinate or Junior Debt

Subordinate debt is debt that ranks below all other debts should a company go bankrupt. Because subordinate debt is unsecured and is repayable only after all other debts have been paid, it represents a higher risk to the lender. Lenders therefore charge a higher rate of return than on senior debt due to the increased risk. In the case of subordinate debt, lenders can agree between themselves as to who will take priority to receive payment first in the event of bankruptcy. By means of these agreements, subordinate debt can be split into tiers or “tranches”. Tranches of debt refer to the risk-return relationship between the tiers. The lowest tranche gets paid last, but also charges the highest interest rate to cover the increased risk of default. The highest tranche is paid first, but charges the lowest interest rate.
6.5 Asset Based Loan

An Asset Based Loan (ABL) is also sometimes referred to as “factoring”. An acquiring company looking to raise funds to make a purchase can use the target’s short-term assets, accounts receivable and inventory, to secure funds. These types of loans require a third party who is willing to take on the risk on the collection of another company’s short-term assets.

Accounts receivable (AR) are debts owed to the target company, but payment may not be due for 30-90 days. ABLs are a way of unlocking these funds before the collection date is due. In a similar fashion, a target company’s inventory may have a high likelihood of being sold in the event of bankruptcy, so this is an asset that can be loaned against to unlock potential value before actual sale.

An ABL lender’s credit decision is based on the belief that at any given time the borrower’s accounts receivable and inventory can be sold to generate enough proceeds to pay the loan in full (Bothwell, 2007). An ABL lender will discount both the AR and inventory at a rate that is heavily influenced by the particular risk profile. For example, if a target’s AR is $100 collectable in 60 days, an ABL may discount the asset and offer $80 immediately against the opportunity to collect the full amount when it becomes due.
Within ABL lending on AR, there are two possible models. The first is where the lender assumes responsibility for the collection of the AR, and the second is where the organization collects the AR and pays off the loan to the lender. In the second model, cash receipts of the borrower are typically reviewed on a daily basis and allocated to pay down the loan.

6.6 Mezzanine Debt

Mezzanine debt is short-term debt at higher interest rates than junior and senior debt. In 2010, mezzanine interest rates in North America ranged approximately from 13% to 19%p.a. This type of debt is usually considered when an organization has exhausted its access to junior and senior debt, but does not want to give up equity. In some mezzanine loan structures, a loan can be turned into shares depending upon certain trigger events in the future.
6.7 Bridge Loan

A bridge loan is a means of accessing temporary financing to “bridge” the borrower to a time when more permanent debt or equity is available (Miller K., 2011). Bridge loans are very common in M&A transactions where the transaction is time sensitive and has to close before other debt or equity markets can be accessed. Bridge loans are short-term loans and are expensive, because the borrower has limited options. Bridge loans are usually sought when an acquiring company needs quick access to capital to finance an acquisition, planning to pay off the loan quickly once the business has changed hands.

6.8 Equity

Equity can be used to finance transactions where an acquiring company wishes to spread the financial risk, is comfortable taking on a partner, or wishes to incentivize business continuity by having the target retain partial ownership of the business post-deal. Using equity in this manner incentivizes equity holders to increase value, and therefore increase accretion. Investor confidence is often closely linked to a confidence in the business owner’s ability to run it profitably. During periods of change, such as an M&A transaction, keeping previous owners on as minority shareholders incentivizes them to stay on as business advisors, partially hedging any investor concern over new ownership for day to day operations.
6.8.1 Spreading the Financial Risk & Partnerships

Many M&A deals, particularly where the buyer is a financial buyer, are partnerships. Private Equity (PE) funds are specialists in spreading the risk of financing a venture by themselves, especially when a PE firm may not have specialized industry knowledge. PE firms usually have expertise in particular markets and industries. In deals involving their own area of expertise, firms will be the senior equity investor and invite other PE groups to join the deal as junior investors. By working in this way, PE firms spread the risk of their investments by diversification while also increasing their buying power.

6.8.2 Business Continuity and Equity Ownership

Equity can be used to finance a deal where an acquirer needs to have assurances of business continuity post-deal. Target owners can be given shares of the new merged organization to give them an incentive to maintain customer relationships and assist in the change management process while the business is being integrated into the acquiring company.

Equity is a cheap way to finance M&A deals when cash is scarce. The 2008 recession caused other means of finance, in particular debt finance, to dry up. Companies were forced to offer equity in their organizations in order to raise capital. In figure 19, a significant spike in the gross amount of equity offerings in the U.S. and Canada is visible in 2009 at a time when organizations had to seek out alternatives to bank loans.
Gross Equity Offerings in North America 2006 - 2011

Figure 19 - Gross Equity Offerings in North America 2006 – 2011 (Capital IQ, 2011)
6.9 Earn out incentives

Earn out incentives are another way of financing part of an M&A deal. This method is often used with small targets in high growth or fluctuating markets. Based on future market projections and predicted earnings that are hypothetical, the acquirer pays 60-80% of the asking price upfront through debt and cash, and the remainder of the price is “earned” as the target company hits its projected earnings or other objectives. If the company doesn’t hit these objectives, then the buyer doesn’t have to pay the earn out amount.

Earn outs are an effective way to limit unrealistic future earning estimations during the deal. They also maintain leadership within the company for business continuity. This method is an effective way to limit the company’s initial debt load, by offsetting it, based on future performance objectives.

6.10 Holdbacks

Holdbacks are a mechanism to create conditional financing in an M&A deal. In a similar fashion to earn outs, holdbacks set up post-deal trigger events that determine if additional payment will be made from the buyer to the seller. Unlike earn outs, which are based on trigger events, mostly in the control of the company such as sales, revenue, and customer satisfaction, holdbacks are used for external triggers such as pending legal, regulatory or environmental action. A holdback payment may be subject to the resolution of a lawsuit in the target company’s favor. Holdbacks can be used to bridge valuation gaps that exist due to pending external events.
6.11 Combined Acquisition Loans

Most acquisitions are funded by a combination of methods to diversify risk for lenders while also giving buyers flexibility. The majority of acquisitions are at least partially funded by debt. One lender, or a combination of many can provide this debt.

For example:

Purchase prices are often a multiple of cash flows or EBITDA. If we assume in the example depicted in table 6 that the purchase price of a business is 8 x EBITDA, the transaction could be structured in any of the following ways:

<table>
<thead>
<tr>
<th>Option A</th>
<th>Option B</th>
<th>Option C</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Senior debt 4 x EBITDA</td>
<td>• Senior debt 4 x EBITDA</td>
<td>• Senior debt 4x EBITDA</td>
</tr>
<tr>
<td>• Mezzanine debt 2 x EBITDA</td>
<td>• Junior Debt 2 x EBITDA</td>
<td>• Asset based loan on Accounts Receivable and</td>
</tr>
<tr>
<td>• Earn out 2 x EBITDA payable over three years subject to expected revenue growth targets</td>
<td>• Private Equity partnership 2 x EBITDA</td>
<td>Inventory 2.5 x EBITDA</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Earn out 1.5 x EBITDA</td>
</tr>
<tr>
<td></td>
<td></td>
<td>payable over three years</td>
</tr>
<tr>
<td></td>
<td></td>
<td>subject to expected revenue growth targets</td>
</tr>
</tbody>
</table>

*Table 6 – Examples of deal financing structure*
7: M&A Success Factors

The success of an M&A deal is complex and depends on a great number of factors coming together as one under the same corporate roof. There are many elements that can influence the success or failure of an M&A throughout the deal making process and during operations following the transaction. Seasoned M&A veterans suggest that at the “hundred thousand foot level” there are five main elements that determine M&A success (Dillon, 2011):

1. A clear and thoughtful strategy for combined operations post-deal
2. Realistic identification of synergies between the buyer and target organization
3. Effective operational integration in a timely manner
4. Effective cultural integration in a timely manner
5. Clear leadership throughout the M&A process and following the transaction

The following sections of this report discuss some of the common issues that affect the above criteria.
8: Issues Affecting the Deal Pre-closure

Every day, M&A transactions are announced, but how many of those actually close? Data shows that a significant percentage of the deals announced in North America fall apart before the deal is completed.

Figures 20 and 21 compare announced M&A transactions with cancelled transactions in Canada and the U.S. over the past three years. To allow for the inclusion of cross border transactions, the location of each deal is defined by the location of the target company in this comparison.

![Canadian M&A Pre-closure Deal Cancelations](image)

*Figure 20 – Canadian M&A deal cancelations 2008 – 2010 (Capital IQ, 2011)*
While the rate of deal failure has declined in both countries over time, there are still a significant percentage of announced transactions that fail before completion. In 2010, 9.6% of transactions in Canada and 4.8% in the U.S. were cancelled before closure. Figures 20 and 21 show that your chances of having an M&A transaction cancelled differed significantly between Canada and the U.S. According to this data, there was a 4-6% difference between the two geographies each year of the past three years. This data suggests that M&A deals are more likely to move to a contract in the U.S. than in Canada.
It is very difficult to accurately analyze the reasons for the failure of particular deals as in almost all cases, confidential information would be required. However, there are some issues that commonly occur. M&A practitioners should be aware of these in order to minimize their chances of pre-deal failure.

8.1 Disclosure & Misrepresentation of Information

A study of M&A deals in 2009 and 2010 found that 93% of transactions included a closing condition that all representations of the target company must be accurate except to the extent that inaccuracy would not have a material adverse effect (Stikeman Elliot & Goodmans Lawyers, 2011). In plainer terms, this means that, if the target misrepresents itself in any way or fails to disclose a material fact, the buyer has the right to terminate the deal and/or potentially seek legal recourse. In addition, 100% of deals studied included a “Material Adverse Change/Effect” right, which is also referred to as a “buyer walk right”. This entitles a buyer to walk away from the deal in the event of any change, event, inaccuracy or circumstance that may occur. In each of these scenarios, it is in the seller’s interest to disclose absolutely everything about the business to the best of the seller’s ability, in order to avoid costly deal cancelations at a later date and to avoid giving the buyer the right to walk away from the deal without recourse.
8.2 Pending Legal, Regulatory, and Environmental Issues

The number of lawsuits associated with M&A is on the rise in the U.S., as depicted in Figure 22. While the actual source of this rise is unclear, some experts hint that following the 2008 recession there has been significant fall out over deals that have been abandoned or postponed due to a reduced ability to raise capital during that time. If this is the case, then a decrease in lawsuits should occur as investment capital becomes more freely available.

![Number of M&A Related Lawsuits in the US 2008-2010](image)

*Figure 22 – M&A related lawsuits in the U.S. 2008 – 2010 (Capital IQ, 2011)*

Another potential issue with M&A transactions is that they are often extremely time sensitive. Delays brought on by legal proceedings, regulatory compliance checks, and environmental studies can easily delay a transaction. Opportunistic plaintiffs bringing claims against target companies, be they real or imagined, know that the companies are likely to settle quickly rather than enter a lengthy battle and risk losing a good opportunity (Jones, 2011). When these claims are settled, it encourages the same behavior by plaintiffs in the future.
9: Issues that Affect Value Post-deal

Once a deal is done, it’s up to the buyer to execute operational plans that will generate additional value for the combined businesses. This is a difficult task. The following section discusses common post-deal challenges that can affect the generation of additional value.

9.1 Change Management

As mentioned previously, the failure rate of attempted mergers and acquisitions is estimated to be somewhere between 70% and 90%. This includes M&A that fail to generate expected value, as well as M&A transactions that actually reduce the value of the companies involved (Christensen, 2011). This implies a significant disconnect between the expectations of M&A investors and reality.

Many companies underestimate the extent of the disruption that is likely to be created by an M&A transaction. In the vast majority of such transactions people are fired or laid off at all levels of the company. Additionally, there are usually significant changes to corporate identity and company culture, creating high levels of uncertainty which make people nervous and cause them to consider options elsewhere. This process of change can be extremely disruptive to the organization, making it less productive and therefore diminishing the potential value to be gained by the M&A transaction.
One of the most disruptive, and therefore destructive changes in an organization can be a change of leadership. Instability in the executive leads to a loss of knowledge, damage to customer and investor relationships, and delays or terminations of strategic projects. Research shows a strong correlation between executive turnover and poor company performance (Shill, 2008).

A study of approximately 5,000 M&A transactions involving 1000 target firms, and including 23,000 executives, over a period of 17 years was undertaken in 2008 to determine the effect of an M&A event on senior leadership. The study looked across a variety of industries that are shown in table 7 (Krug, 2008). To establish the extent to which an M&A transaction disrupts senior leadership, the first step was to compare the rate of executive turnover in merged companies when compared with non-merged companies. Results are shown in figure 23.

**Data Sample – Target firms and executives**

<table>
<thead>
<tr>
<th>No.</th>
<th>Industry</th>
<th>Targets</th>
<th>Executives</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Financial services</td>
<td>83</td>
<td>2,407</td>
</tr>
<tr>
<td>2</td>
<td>Securities</td>
<td>18</td>
<td>508</td>
</tr>
<tr>
<td>3</td>
<td>Telecom</td>
<td>62</td>
<td>910</td>
</tr>
<tr>
<td>4</td>
<td>Oil and gas</td>
<td>66</td>
<td>1,331</td>
</tr>
<tr>
<td>5</td>
<td>Consumer</td>
<td>178</td>
<td>4,332</td>
</tr>
<tr>
<td>6</td>
<td>Retail</td>
<td>165</td>
<td>4,106</td>
</tr>
<tr>
<td>7</td>
<td>Manufacturing</td>
<td>255</td>
<td>4,651</td>
</tr>
<tr>
<td>8</td>
<td>Service</td>
<td>57</td>
<td>1,189</td>
</tr>
<tr>
<td></td>
<td>Mergers</td>
<td>874</td>
<td>19,434</td>
</tr>
<tr>
<td>9</td>
<td>Control group</td>
<td>145</td>
<td>3,573</td>
</tr>
<tr>
<td></td>
<td>Total firms</td>
<td>1,019</td>
<td>23,007</td>
</tr>
</tbody>
</table>

*Table 7 – Breakdown of industries, targets and executives included in Krug’s executive churn survey (Shill, 2008)*
Top management turnover rates in merged and non-merged firms

Figure 23 – A comparison of executive turnover between companies that have and had not experienced a merger (Shill, 2008)

Figure 23 clearly shows that there is a statistical difference in rates of executive turnover in companies that experienced an M&A transaction when compared with those companies which did not. In fact, there is a 200% increase in executive churn in the first year, which then backs off to about a 100% increase from year two to year ten. It is also interesting to note that rates of executive turnover pre-merger are higher in companies that went on to complete a transaction than in those that did not. Perhaps executive turnover could be seen as an early indicator for investors wishing to know how likely a target is to enter into M&A negotiations.
It is not uncommon for a company to experience multiple mergers during the life of the company. What happens to executives in firms acquired more than once? In an attempt to answer this question, the data set was split into two groups: those firms that have experienced one M&A transaction, and those which have experienced more than one. The data is shown in the figures below.

**Top management turnover rates in firms acquired only once**

![Graph showing executive turnover rates](image)

**Figure 24 – A comparison of executive turnover between companies that have experienced one M&A transaction and those who have not experienced M&A (Shill, 2008)**

As shown in figure 24, firms that experience one M&A transaction, also experience an approximate 70-120% increase in executive turnover from year one to year ten. For further information, figure 25 shows a comparison between non-merged companies and those that have experienced multiple M&A transactions.
Top management turnover rates in firms acquired more than once

![Graph showing executive turnover rates](image)

Figure 25 – A comparison of executive turnover between companies that have experienced multiple M&A transactions and those who have not experienced M&A (Shill, 2008)

Figure 25 shows a 400% increase in senior leadership turnover in the first year of a second transaction. The firms represented here lost an average of 48% of their senior leadership in the first year of transition; this would have created an enormous disruption to business operations. Following the spike in turnover in the first year, executive turnover decreases slightly and sits between 150%-250% that of non-merged firms for the next 9 years.
Firms that are acquired multiple times during a short time period experience much higher and more unpredictable rates of turnover among their executives than either non-merged firms or target firms which have been acquired only once (Shill, 2008). The leadership churn implies exceptionally high organizational uncertainty and would, without question, have a very significant impact on the company’s bottom line.

In order to dispel any notion that this very significant trend of executive turnover and disruption is a phase that is unique to recent M&A, the Shill study has been extended to compare data over longer periods of time. Figure 26 shows a comparison between companies that experienced M&A during the 1980’s, 1990’s and 2000’s and non-merged firms over the same time period. The data gives a clear indication that the executive churn phenomenon is not a point in time issue, but one that is likely to occur in all M&A transactions if it is not mitigated effectively.
Top management turnover rates in M&As from the 1980s, 1990s, and 2000s

Figure 26 – A comparison of executive turnover between companies that have experienced multiple M&A transactions in the 1980s, 1990s and 2000s with those who have not experienced M&A (Shill, 2008)

Krug’s study found that poor post-merger performance and unrealized synergy gains cause more than half of all M&A to fail. The negative effects of M&A activity on target and acquirer morale and therefore on productivity is substantial. Change management is often implemented poorly or overlooked completely which ultimately erodes leadership, and fails to establish leadership continuity. This quickly has a diminishing effect on the value of the transaction.
In summary, these findings show that high rates of executive turnover will be experienced in any company post M&A. It is inevitable that leadership instability will occur in the organization unless specific action is taken to unify and strengthen any new leadership team. If action is not taken to retain leaders, or to quickly create new and cohesive leadership in the merged company, productivity and morale will fall. This will be damaging to long-term performance.

A certain amount of leadership churn is likely to occur in the first year following M&A despite any mitigating activities the company may put in place. It is however, the ongoing increased turnover that organizations can take action against, to retain as much value from the merger as possible (Shill, 2008).
9.2 Culture & Conflict

The integration of any two groups can be a daunting and difficult task. In the case of M&A transactions, two completely separate companies are being molded into one, often under stressful conditions and tight timelines. Cultural differences between organizations involved in this process can lead to confusion, fear, conflict, productivity loss, decrease in morale, and a decrease in employee retention. When organizations pay little or no attention to this important issue they incorrectly assume that two productive companies joined into one easily become one super productive company. This is rarely the case.

At a CEO round table discussion hosted by the Harvard Business Review, Denis Kozlowski, CEO of Tyco, stated “People are normally productive for about 5.7 hours in an eight-hour business day. But any time a change of control takes place, their productivity falls to less than an hour” (Donahue, 2001). Mr. Kozlowski is referring to the natural human tendency to be distracted by thoughts and fears about the impact of change to one’s self. In an M&A situation where levels of uncertainty are high, the actions of an acquiring company could reduce the productivity of both the target organization and its own company by up to 82% (Donahue, 2001). This is a serious problem and demonstrates the potential very significant impact of miscommunication and conflict between two corporate cultures.
M&A deals are often subject to non-disclosure clauses that make it very difficult to communicate likely outcomes and future plans until a deal is completed. This lack of communication is likely to cause additional stress and fear for workers. Organizations need to plan for pro-active mitigating strategies in order to minimize reduced productivity caused by uncertainty.


10: Strategies to Mitigate Risks

This section of the document assumes that the reader is a buyer and not a seller. It looks at strategies to mitigate the risks from a buyer’s perspective.

10.1 Disclosure and Due Diligence

Disclosure by the seller is extremely important to a deal. It is important to establish trust and open communication, which encourages the seller to disclose all of the hidden secrets a business might contain. To facilitate this kind of relationship it is very common to use a non-disclosure agreement (NDA) where both parties choose to share confidential information such as financial statements and intended deal structure with each other. Sharing this information with others would be considered a breach of the agreement and would trigger some form of payment or legal action.

M&A transactions require a large number of resources and a high level of commitment by both the buyer and seller. There is much at stake. A material adverse effect (MAE) is a clause that allows the acquirer to refuse to complete the deal if any new material or information is discovered that has not been disclosed by the seller and has an adverse effect on the buyer's ability to run the business successfully. The inclusion of an MAE clause encourages a seller to disclose as much as possible about the business, because failure to comply means that the buyer can walk away leaving the seller with resources sunk into the deal but without a sale.
10.2 Deal Protection

Letters of intent (LOI) are a good way to begin negotiations and to establish executive buy-in. They are essentially an executive summary of the deal and terms in a format that can easily be digested by directors, the board, and management. An LOI can speed up the negotiation process by accelerating buy-in. However, in situations where confidentiality is an issue, LOIs can be a signal to competing buyers of your intentions and so they have to be used with care, or alternatively covered by a confidentiality agreement.

One such agreement is called a “No Shop Provision” where the seller agrees to keep the buyer’s offer confidential. This stops a seller from using an LOI to shop around in order to get a better price. If the seller breaks the agreement, the seller has to pay a set fee to the intending buyer.

One way of covering the buyer’s risk of committing resources to a deal and then having the seller back out at the last moment is a termination fee. A termination fee, sometimes referred to as a breakup fee, is usually a set percentage of the overall deal value. In 2010 in North America the average termination fee was 2-6% of the deal (Practical Law Company, 2011). This obviously creates an incentive for businesses to pursue only M&A activity arising out of serious interest.
There are many uncertainties in buying a business, including the prospect of events that may or may not happen in the future. Examples include pending legal decisions and regulatory changes, which can have a serious effect on business valuations. A hold back is a means of limiting exposure to potential future events. A hold back is an amount of money held back from the transaction for a specific time period pending the outcome of a future event. An example of this might be an environmental regulatory change that would lead to expensive clean up operations at multiple factories owned by a target business. The buyer and seller could agree upon an amount that represents the cost of this risk, which could then be subtracted from the deal value. The business is then sold with a hold back period of 6 months. If the legislation comes into effect within six months, the buyer keeps the hold back amount. If the legislation doesn't come into effect in that time period, the money is paid to the seller.

10.3 Realistic Estimation of Value Creation

Too often M&A practitioners over estimate the value creation potential of a particular transaction or the time and resources required to create it. An unrealistic perception of value creation is one of the key factors leading to M&A failure. M&A veterans advise heavily discounting your estimations so that a buyer is not caught off guard ruining the business case for the acquisition in the first place (Miller K., 2011).
10.4 Have a Plan

Businesses don’t just integrate themselves. Organizations looking to participate in an M&A transaction need to engage in very clear planning for the ways in which the transaction will be completed and how the businesses will integrate and/or interact post-deal.

It is likely that analysis has been done to identify how the two businesses can be combined to create additional value, but all too often these value adds don’t materialize. Former Proctor and Gamble (P&G) CEO, A.G. Lafley, stresses the importance of clear plans for achieving integration. In his case, P&G has been able to generate more value than would have been predicted, through strict project management. In P&G’s case, each value add is assigned to an executive sponsor and carefully tracked. By engaging in this kind of planning, P&G was able to generate 150% of the value predicted when it purchased Gillette (Dillon, 2011).

10.5 Integration

M&A is said to be similar to a marriage. It’s not how compatible the two businesses are, but rather how they identify and deal with their differences that count (Prashant Kale, 2009). In order to give an M&A transaction the best chance of success, it is very important that the integration of the separate businesses is fast and effective. This requires planning.
It is often incorrectly assumed that M&A requires the complete integration of one business with another, including use of the same offices, shared services, and the same reporting structure. In fact, M&A activities occur along a sliding scale of integration options, from businesses which continue to operate as autonomous partners, to full integration. Historically, most buyers will have forced their values and corporate structure on the seller. However it is now widely acknowledged that this kind of approach can destroy value by dramatically increasing executive turnover and impacting morale.

As a result, businesses now choose the areas in which to combine business functions very carefully, often leaving the acquired business to operate as a separate division under its own rules and structure. In this way the merger or acquisition is much more like a partnership or strategic alliance for operational purposes than a takeover (Prashant Kale, 2009).

There are advantages and disadvantages of operating as partners under a parent company or as an autonomous subsidiary. One of the advantages is that the new relationship is easy for each business to accept quickly. There is no dramatic change in culture or operations at either company. However, operating as autonomous partners doesn't allow for as many cost savings as a fully integrated business. As seen in Figure 26 the level of integration is directly related to the speed at which it can be implemented. The more departments, services and people who have to form new relationships and process, the longer it takes to integrate.
The partnership approach is being used by some large organizations. Rather than rushing to integrate newly acquired businesses into their corporate structure, they take time to identify which parts are compatible and which parts should operate independently. The framework depicted in figure 27 is a quick guide to making that decision.
**Who Should Partner**

Some companies are more suited than others to the hands-off approach.

<table>
<thead>
<tr>
<th>What kind of resources does the acquired company have?</th>
<th>INTEGRATION</th>
<th>PARTNERING</th>
</tr>
</thead>
<tbody>
<tr>
<td>The same or similar resources</td>
<td>Complementary, superior, or unique resources such as brands or technologies</td>
<td></td>
</tr>
</tbody>
</table>

| What will create value after the takeover? | Reduction of costs by combining assets and activities, or gaining economies of scale | Growth in revenues by entering new markets or new products, and sharing best practices |

| What kind of company is the acquirer? | Hierarchical, with a low tolerance for ambiguity; a desire to teach; an emphasis on getting results | Collaborative, with a high tolerance for ambiguity; a willingness to learn; a long-term player |

*Figure 27 – Guide to partnership vs integration (Prashant Kale, 2009)*

Full integration theoretically allows for cost reductions through shared services and a reduced head count. However it is more risky than an M&A partnership. Full integration takes time and resources, and it is often not achievable in reality. Buyers should be wary of M&A business cases that rely heavily on full integration in a short period of time. These kinds of proposals are some of the most risky ventures from an integration perspective.
While cost savings are a valid M&A value proposition, they can be replicated by competition and at some point costs will not be able to be lowered further which questions the ongoing sustainability of a business model focused on cost savings alone. Bringing new products to new markets is in many cases a more sustainable business model. This approach requires less integration and can therefore be executed more rapidly.

When a business acquires another business, it has a series of questions to ask itself in regard to integration:

- What will the post deal organizational structure look like?
- What business functions, if any, will be combined post deal?
- Which employees will stay and which employees will leave?
- How much autonomy will each business be given?
- What are the vision, values, and goals that exist and to whom do they apply?

### 10.6 Human resources

M&A transactions signal significant periods of change for an organization. For those M&A deals seeking to reduce costs, human resources cuts are inevitable. It is very important for a buyer to have a plan for the best use of company employees to be made as early as possible.
The state of human resources has a direct impact on investor and employee confidence. There are many prominent examples of share prices plummeting when a key executive leaves. For example, stock prices of Apple Inc were affected negatively by announcements about health problems being experienced by its CEO, Steve Jobs. The value of Apple to an investor is the company, but there is also value that arises from confidence in its leadership.

Employees want job security and a sense of confidence about what they do. We know that executive turnover after an M&A deal increases, but what about the turnover of other employees? It is the skilled and talented workers who will have the greatest number of opportunities elsewhere if they leave an acquired company. If they perceive that their job security or enjoyment is under threat then it makes sense that they may decide to leave. It is important that organizations are able to retain the workers they want to keep and maintain morale even when the company is streamlining or downsizing its human resources. It is the key, talented employees who add the most value to a business and their resignations will erode the confidence and morale of co-workers.

Additionally, companies seeking to integrate business units need to consider how the employees of each will interact with each other. Internal power struggles or poor teamwork waste time and erode value. Some integration strategies suggest letting managers within the organization select their own teams post-merger. This limits the amount of conflict within that team moving forward.
10.7 Incentives

When key people leave a business, investor confidence falters, knowledge is lost, and morale goes down. Why not guard against this possibility by creating incentives for key employees to stay? The period of transition from one business owner to another is an uncertain time where any security is greatly valued. M&A transactions will often include bonus incentives to key employees who stay 12 months beyond the transaction date. This results in a sense of stability within the company during a time of change.

When a business changes hands, there is a period of transition when the new owners have to quickly learn how to operate the business effectively. In the case of a private business there will have been a lot of implicit knowledge in the head of the owner and key management or executives. In order to smooth the transition, a buyer can include earn outs incentives to previous business owners in the acquisition agreement.

Earn outs are a means of incentivizing business owners to disclose realistic expectation of business performance. An example earn out may look at the seller’s projected revenue for the next three years and set incentive payments to the seller if those targets are met. An earn out effectively does two things;

a) It encourages realistic future revenue projections by the seller. If projections are met, the seller receives an incentive payment. The more realistic the projection therefore, the higher the likelihood of being paid.
b) Earn outs incentivize business owners and executives to stay on at a business for a period of time post sale to make sure the business is run effectively.

From a buyer’s perspective earn outs offer the advantage of staged payments for the transaction. The buyer does not have to come up with the full purchase price all at one time. This can save interest on debt financing, and/or give the buyer time to access financing at favorable terms over a longer period of time.

10.8 Consider Your Alternatives: M&A is one of many options

With such a high percentage of M&A failing to generate their expected value, it is important to realize that M&A will not be the right answer for every situation. A study published in the Harvard Business Review looks at the degrees of success achieved by a variety of ways of adding skills and resources to a business. The study found that companies engaging in M&A alone are 46% less likely to survive than companies expanding through a combined approach of internal development, partnerships, and M&A (Mitchell, 2010).

The author of the study, Will Mitchell, then goes on to suggest a framework for assessing whether a Merger or Acquisition is the right choice for a company at a particular time. The framework asks three questions which guide the outcome to one of four potential options: Internal development, Purchase contract, Alliance, or Acquisition. His suggested flow Figure is seen below in figure 28.
Finding Your Way to the Resources You Need

Go after new resources in the simplest way that will satisfy your strategic goals. For instance, when deciding whether to develop them internally or externally, tweak the ones you already have if they’re highly relevant to what you seek. Business acquisition is your most complex option; reserve it for when it really pays to have a close relationship with your provider.

-内部开发或外部采购？
  - 相关度：现有资源对战略目标的贡献
    - 低：内部开发
    - 高：外部采购
- 联盟或并购？
  - 非核心资源与资源提供者的紧密程度
    - 高：联盟
    - 低：并购

Figure 28 – M&A alternatives flow chart (Mitchell, 2010)
11: Conclusions and Recommendations

A consideration of the factors that contribute to increased M&A activity suggests that 2011 and 2012 is likely to be the next period of M&A boom. Moneylenders are becoming more adventurous with capital. Global interest rates are low, and businesses have been holding back on potential transactions until the economy recovers.

In the U.S. alone, it is estimated that 8 million privately held companies will change hands in the next ten years due to baby boomer retirements. The next generation has shown significantly less interest than earlier generations in continuing to own family businesses and this change is expected to create a dramatic increase in the number of companies for sale.

During the recession, the number of strategic transactions decreased greatly while financial transactions remained fairly steady. It’s expected that the largest growth sector will be strategic buyers coming out of the 2008 recession. Despite this trend, PE and managed investment funds will be significant sources of M&A financing in 2011 and 2012. These groups have significant uncommitted capital that they must put to work in the near future.
The way in which deals are structured and financed will continue to become increasingly creative. Currently, most acquisitions are being funded by a combination of methods to diversify risk for lenders while also giving buyers flexibility. This trend will continue as cautious investors and lenders look to hedge risks and maximize returns through creative deal structures. An increase in earn outs and asset based loans are expected.

In terms of the actual acquisition process, it is important that the buyer protect its interests through confidentiality agreements and measures to encourage full disclosure. This saves time and resources, and also increases buy-in by the seller. Penalties such as termination clauses can also be integrated into the deal to protect against buyers or sellers backing out of the deal at the eleventh hour.

Beyond the purchase of the business M&A literature and this paper indicate that there are three key elements that determine M&A success. These include:

A clear and thoughtful strategy for combined operations post-deal

Businesses don’t integrate themselves. They need strong leadership and a show of business continuity to employees, suppliers, customers and investors. Executive attrition increases significantly around M&A activity and this erodes continuity and hence value. Strategies to retain key employees for at least a period of time after the transaction are a good investment. These might take the form of earn outs, equity ownership, and financial incentives.
Realistic identification of synergies between the buyer and target organization

Sometimes it's more cost effective to have businesses operate as partners rather than as integrated businesses. While this reduces the list of potential synergies, it saves time and boosts moral where two companies are very different in culture, corporate structure and autonomy. Forcing synergies upon a business will in many cases decrease value propositions through delays, decreased moral, and incorrect assumptions.

Effective cultural and operational integration in a timely manner

Recognition of different corporate cultures is important for M&A success. Where cultures clash there will be costly delays, employee attrition, and a lack of focus. M&A practitioners need to understand how cultures differ before making the deal. Culture is a soft element of M&A, but also one of the hardest elements of a business to change. A realistic assessment of cultural integration will be especially important where businesses need to be operational quickly after the M&A integration. In cases of strong cultural differences, alternatives to full integration need to be identified and given due consideration.

In conclusion, there will be many opportunities for well-planned M&A transactions in 2011 and 2012. However, the market will favor those M&A deals that are creative, realistic and intelligent.
12: Appendix A – M&A Global Trends by Activity Type 2007-2010

Global deal summary

<table>
<thead>
<tr>
<th>Demerger</th>
<th>Asset/subsidiary disposals</th>
<th>Joint Venture</th>
<th>Merger</th>
<th>Other private M&amp;A</th>
<th>Public hostile acquisition</th>
<th>Public recommended acquisition</th>
<th>Take Private</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q1 2007</td>
<td>6</td>
<td>62,680</td>
<td>270</td>
<td>172,308</td>
<td>3</td>
<td>481</td>
<td>8</td>
<td>27,874</td>
</tr>
<tr>
<td>Q2 2007</td>
<td>8</td>
<td>20,046</td>
<td>103</td>
<td>316,929</td>
<td>8</td>
<td>6,822</td>
<td>4</td>
<td>20,204</td>
</tr>
<tr>
<td>Q3 2007</td>
<td>5</td>
<td>20,210</td>
<td>200</td>
<td>172,305</td>
<td>7</td>
<td>4,265</td>
<td>6</td>
<td>7,574</td>
</tr>
<tr>
<td>Q4 2007</td>
<td>10</td>
<td>29,913</td>
<td>206</td>
<td>336,851</td>
<td>4</td>
<td>1,825</td>
<td>3</td>
<td>2,265</td>
</tr>
<tr>
<td>2007 TOTAL</td>
<td>29</td>
<td>142,651</td>
<td>1,299</td>
<td>973,523</td>
<td>20</td>
<td>13,024</td>
<td>21</td>
<td>62,518</td>
</tr>
<tr>
<td>Q1 2008</td>
<td>5</td>
<td>120,242</td>
<td>247</td>
<td>125,903</td>
<td>1</td>
<td>118</td>
<td>3</td>
<td>1,393</td>
</tr>
<tr>
<td>Q2 2008</td>
<td>5</td>
<td>56,115</td>
<td>257</td>
<td>133,114</td>
<td>5</td>
<td>3,229</td>
<td>4</td>
<td>5,304</td>
</tr>
<tr>
<td>Q3 2008</td>
<td>5</td>
<td>23,105</td>
<td>245</td>
<td>103,170</td>
<td>4</td>
<td>1,616</td>
<td>2</td>
<td>1,727</td>
</tr>
<tr>
<td>Q4 2008</td>
<td>3</td>
<td>4,427</td>
<td>155</td>
<td>142,599</td>
<td>3</td>
<td>1,668</td>
<td>1</td>
<td>222</td>
</tr>
<tr>
<td>2008 TOTAL</td>
<td>25</td>
<td>289,750</td>
<td>925</td>
<td>966,416</td>
<td>14</td>
<td>6,821</td>
<td>10</td>
<td>18,874</td>
</tr>
<tr>
<td>Q1 2009</td>
<td>1</td>
<td>1,066</td>
<td>132</td>
<td>74,229</td>
<td>1</td>
<td>675</td>
<td>2</td>
<td>941</td>
</tr>
<tr>
<td>Q2 2009</td>
<td>4</td>
<td>10,393</td>
<td>176</td>
<td>163,371</td>
<td>1</td>
<td>123</td>
<td>3</td>
<td>6,084</td>
</tr>
<tr>
<td>Q3 2009</td>
<td>3</td>
<td>2,829</td>
<td>219</td>
<td>111,330</td>
<td>1</td>
<td>771</td>
<td>1</td>
<td>263</td>
</tr>
<tr>
<td>Q4 2009</td>
<td>7</td>
<td>29,554</td>
<td>202</td>
<td>126,573</td>
<td>3</td>
<td>14,883</td>
<td>6</td>
<td>4,350</td>
</tr>
<tr>
<td>2009 TOTAL</td>
<td>15</td>
<td>39,883</td>
<td>761</td>
<td>492,813</td>
<td>8</td>
<td>16,429</td>
<td>12</td>
<td>14,880</td>
</tr>
<tr>
<td>Q1 2010</td>
<td>6</td>
<td>8,317</td>
<td>175</td>
<td>202,842</td>
<td>3</td>
<td>2,686</td>
<td>0</td>
<td>2,020</td>
</tr>
<tr>
<td>Q2 2010</td>
<td>6</td>
<td>8,155</td>
<td>241</td>
<td>146,695</td>
<td>1</td>
<td>3,214</td>
<td>7</td>
<td>16,214</td>
</tr>
<tr>
<td>Q3 2010</td>
<td>6</td>
<td>17,377</td>
<td>250</td>
<td>127,761</td>
<td>1</td>
<td>189</td>
<td>6</td>
<td>17,177</td>
</tr>
<tr>
<td>Q4 2010</td>
<td>3</td>
<td>7,995</td>
<td>294</td>
<td>215,254</td>
<td>9</td>
<td>11,753</td>
<td>247</td>
<td>251,433</td>
</tr>
<tr>
<td>2010 TOTAL</td>
<td>19</td>
<td>42,083</td>
<td>637</td>
<td>733,176</td>
<td>5</td>
<td>6,291</td>
<td>28</td>
<td>50,187</td>
</tr>
<tr>
<td>Q1 2011</td>
<td>2</td>
<td>18,020</td>
<td>177</td>
<td>184,233</td>
<td>3</td>
<td>3,147</td>
<td>9</td>
<td>1,402</td>
</tr>
<tr>
<td>TOTAL</td>
<td>89</td>
<td>230,344</td>
<td>4,005</td>
<td>2,874,058</td>
<td>49</td>
<td>43,782</td>
<td>50</td>
<td>168,290</td>
</tr>
</tbody>
</table>

(Allen & Overy, 2011)
## Americas Target Multiples

<table>
<thead>
<tr>
<th>Target Multiples</th>
<th># Deals</th>
<th>Min - Max</th>
<th>Median</th>
</tr>
</thead>
<tbody>
<tr>
<td>Free Cashflow</td>
<td>357</td>
<td>.01 - 1925.25</td>
<td>29.30</td>
</tr>
<tr>
<td>Income B/F XO</td>
<td>366</td>
<td>.00 - 2300.54</td>
<td>22.40</td>
</tr>
<tr>
<td>Net Income</td>
<td>374</td>
<td>.00 - 2300.54</td>
<td>22.34</td>
</tr>
<tr>
<td>EBIT</td>
<td>399</td>
<td>.00 - 983.92</td>
<td>13.51</td>
</tr>
<tr>
<td>Net Income + Deprec</td>
<td>452</td>
<td>.00 - 2300.54</td>
<td>13.43</td>
</tr>
<tr>
<td>Cashflow from Ops.</td>
<td>446</td>
<td>.00 - 1821.27</td>
<td>12.18</td>
</tr>
<tr>
<td>EBITDA</td>
<td>405</td>
<td>.00 - 394.75</td>
<td>9.30</td>
</tr>
<tr>
<td>Book Value</td>
<td>639</td>
<td>.00 - 1391.42</td>
<td>2.23</td>
</tr>
<tr>
<td>Stockholder Eqty</td>
<td>645</td>
<td>.00 - 811.87</td>
<td>2.15</td>
</tr>
<tr>
<td>Revenue</td>
<td>626</td>
<td>.00 - 2193.78</td>
<td>1.57</td>
</tr>
<tr>
<td>Market Cap</td>
<td>621</td>
<td>.00 - 824.00</td>
<td>1.36</td>
</tr>
<tr>
<td>Enterprise Value</td>
<td>615</td>
<td>.00 - 62.52</td>
<td>1.26</td>
</tr>
<tr>
<td>Total Assets</td>
<td>700</td>
<td>.00 - 1553.25</td>
<td>1.08</td>
</tr>
</tbody>
</table>

(Bloomberg, 2011)
14: Works Cited


http://online.wsj.com/article/SB10001424052748704482704576072050216781160.html


