Merger & Acquisition Focus

Year End 2009

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Good financial projections can help seal your deal

Accurately projecting future earnings for a prospective buyer is critical if a business seller hopes to close an M&A deal successfully. Forecasts should be carefully prepared and, if possible, look appealing to a prospective buyer. Financial projections can also help companies map their progress toward strategic goals and reveal where performance is falling short and how it can be improved.

Long and short of it

Prospective buyers typically use a target's financial projections (along with data such as the seller's assets, debt, overhead expenses and client lists) to make their own performance forecasts, which can be a major factor in their acquisition decision. Depending on your prospective buyer, you may be asked to prepare specific kinds of projections over different time periods to provide them with a rough roadmap to earning their return on investment. Among the most common are:

Cash forecasts. These extremely short-term forecasts predict company earnings and obligations — typically weekly — and are thus reviewed and updated often. Cash forecasts get to the root of a company's health. How much is coming in each week? How much is flowing out? How well are the two balanced?

To prevent wasted time and effort, build your forecast around a few critical data points.

Short-term projections. This type of forecast generally limits itself to the upcoming 12-month period and is updated on a weekly or monthly basis. Short-term projections provide much of the raw material for longer-term projections. Buyers generally plot short-term projections against other data from the same period to determine a company's growth rate, and then compare that rate with the rate of inflation or comparable peers' rates.

Multiyear plans. Forecasts in the three- to five-year range help companies map progress toward long-term objectives. These forecasts are likely to change due to unforeseen events, such as 2008's major market decline and new — or lost — major customers. But prospective buyers often consider it a critical part of their decision making, particularly when the seller is a relatively new company with a short financial history.

Time management

Preparing financial projections can be one of the most labor-intensive and difficult items on a seller's task list. Accuracy and good presentation are essential, but your company's accounting department and financial executives are likely already busy with their usual duties, not to mention other projects associated with selling the business.

To prevent wasted time and effort, build your forecast around a few critical data points, such as:

- ❖ Income statements,
- ❖ Debt to sales ratios,
- ❖ Client growth expectations, and
- ❖ Overall expense rates.

Don't get bogged down in too much detail. Instead, summarize at the division or department level and save the line-item expenses for individual department reviews. You might consider following the "80/20 rule," which assumes that 80% of a company's overall financial results are based on 20% of its cash-flow line items. The rule can help you identify and prioritize income and expense items most significant to your business plans and forecasts.

Also be sure to keep lines of communication open between those preparing projections and managers responsible for key cash flows. For example, your CFO should be informed immediately when a raw material's price rises or a customer account expands, so that your company's projections will reflect those variables.

Forecast foibles

No matter how hard you work, your forecasts will never be entirely accurate. The longer-term the projections, the less accurate they tend to be. Not surprisingly, most companies err on the positive side. In fact, Jeffrey Hooke, author of several M&A advisory books, has noted that in his 20 years in the business he's never seen a forecast that projected declines in profits or earnings.

Even midrange (two- to six-month) projections often are inaccurate. A recent survey conducted by the National Association of Corporate Treasurers (NACT) and strategic advisory firm The Hackett Group found that 80% of the participating 100 companies reported that they were unable to accurately forecast midterm cash flow.

Despite these obstacles, you can improve your forecasts' accuracy. Rather than keeping data apart on standalone spreadsheets, consider using an enterprise resource projection system that pools data in a local area network.

Team players

Preparing your forecasts is only half the battle. The other part is communicating with your prospective buyer. Too often, communication between a selling

The forecast as company physical

Don't wait to sell your company before you prepare financial forecasts. Regularly prepared projections can help you evaluate your company's health and reverse unwanted trends. Specifically, they allow you to:

Clarify goals. Mid- and long-term forecasts enable you to turn strategic goals into specific targets, such as revenue or sales growth numbers. You can modify these targets when conditions, such as the general economy or competitive landscape, change.

See red flags. If your projections divert dramatically from earlier expectations, use this information as a wake-up call and turn your attention to the underperforming division or rising cost of certain supplies.

Conduct postmortems. If your company achieved its growth objectives for the year, but at the expense of higher overhead costs, your future projections should take this into account.

company's financial forecasters and the buyer breaks down in the early stages of a deal, leading to problems down the road. If, for example, your short-term cash flows aren't reported regularly, your buyer may under- or overestimate your company's value.

So make your forecasters part of your M&A deal team, and include them in meetings with all executives and managers who supervise important cash flows. As deal negotiations begin, provide the buyer with frequent short-term forecasting updates — especially if your company has positive news.

Right the first time

Many things can go wrong during a business sale, but few are as damaging as inaccurate financial projections. Make sure you get them right the first time and continue to deliver frequent and accurate updates. ■

Tough call: Deciding to write off goodwill

During economic downturns, your company may face some major goodwill impairment. And if you're thinking about selling, such impairment could affect your M&A deal's value.

Companies in this position must decide whether to write off goodwill — an action that has both pros and cons. Prospective buyers will also have an interest in the decision because it affects the acquired company's long-term performance.

Why do it?

Goodwill, which represents a company's value in excess of tangible assets such as plants, property, inventory and cash, has declined significantly across the corporate landscape in the past two years. Many companies, as a result, have decided to write off their goodwill, particularly those with stocks selling below book value (more than one in six S&P 500 companies in December 2008), including Orbitz and Morris Publishing.

Companies that write off goodwill usually reason that it's a better alternative to having to adjust their company's overall book value downward. Unlike depreciating assets, goodwill remains on balance sheets indefinitely, and a long period of declining goodwill can drag on a company's earnings. Some, therefore, take the losses early and build anew.

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First Financial Northwest, for example, cited several factors that led to its recent $14.2 million write-off:

- The protracted decline in stock prices for all companies in its sector (financial services),
- Lack of merger opportunities, and
- Difficulty of valuing intangible assets such as goodwill in a prolonged recession.

Whether your company is public or private, in banking or another market sector, these factors could justify your own decision to write down goodwill.

Buyer preference

However, keep in mind that, if you're considering an M&A deal, the goodwill decision may not belong entirely to you. Communicate your plans with prospective buyers, because some may oppose it for potential regulatory or legal issues. For example, a lending contract may consider goodwill write-offs to be a violation of covenants.

More often, buyers prefer that their target write off goodwill before negotiating a sale price. In an extreme example, when Sprint bought Nextel in 2008, Sprint was forced to write off about $30 billion in its acquisition's goodwill — essentially wiping out the value of its deal.

Long-term decision

Deciding to write off goodwill isn't an easy decision. Keep the long-term health of your company in mind, and conduct financial forecasts to predict how performance will likely be affected. And if you're considering a sale, let your prospective buyer know what you're thinking, because goodwill write-offs can affect your selling price and even prevent a deal from going forward. ■

Prepare for the worst with a MAC

You're ready to close a business acquisition deal that you hope will provide your company with growth opportunities and long-term cost savings, when your target's rosy financials suddenly lose their bloom. A material adverse change (MAC) clause can provide you with an escape hatch if an extraordinary event adversely affects the seller's projected performance. Although a MAC doesn't guarantee that your exit from a bad deal will be without penalties, it can be a useful tool when you're in a desperate situation.

Popular again

MAC clauses have been included in sales agreements for decades but rarely invoked — until recently. As market conditions started deteriorating in the latter part of this decade, more buyers became willing to claim them.

In 2007, Kohlberg Kravis Roberts (KKR) and Goldman Sachs claimed a MAC to kill their proposed $8 billion acquisition of audio equipment maker Harman International Industries. Others have used

the MAC claim to negotiate better terms. Private equity firm Lone Star, for example, negotiated a 22% purchase price reduction after alleging its acquisition target, Accredited Home Lenders, had experienced a MAC.

Defining and describing

MAC clauses aren't just for large deals. In fact, most transactions include some form of MAC provisions. MACs generally have two main elements:

1. A definition of what constitutes a MAC for the purposes of the deal. Generally, that definition is a relatively sudden event that quickly and negatively affects a business's performance. But you may also want to try to include in your MAC definition a forward-looking component, such as requiring the provision to apply to any event that has a reasonable likelihood of causing a MAC in the future. MAC clauses typically cover the period of time between the signing of the acquisition agreement and the transaction's completion, making it a type of emergency escape clause for buyers.

2. A description of circumstances that would permit a buyer to withdraw from the deal without incurring a penalty. MAC clauses contain a list of carve-outs — exceptions and qualifications that shouldn't be considered when determining if a target company has experienced a MAC. Carve-outs are specific for each deal and negotiated between buyer and seller.

They can include:

- General economic changes that affect the target company's industry,
- Securities law changes that hurt the target's business,
- Changes in the rules of Generally Accepted Accounting Principles, and
- "Acts of God," or unpredictable events such as terrorism or natural disasters.

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Market conditions usually dictate the number and breadth of exceptions included in the clause. In a seller's market — which much of the past decade has been — MAC clauses typically included a wide range of exceptions, making it difficult for buyers to invoke one. As the market has swung in favor of buyers, however, they've enjoyed greater leverage to negotiate only limited exceptions.

Risk allocation tool

Of course, a MAC doesn't exempt buyers from the need to choose their acquisition target wisely and perform extensive due diligence. Instead, think of it as a negotiating tool. You and the seller can discuss what events constitute a MAC as a way to allocate risk between both parties.

Finally, if you end up having to invoke a MAC, keep in mind that you may be in for a legal fight — no matter how well-drafted your clause. Your advisors can help you support your claim, but the seller is likely to work hard to counter it. Sometimes, paying a break-up fee is the best solution. ■

Ask the Advisor

Q. Should my company consider a "virtual merger"?

A: Even when the potential benefits of a merger are enticing, it may not be feasible because of poor economic conditions, lack of financing or regulatory issues. But you don't have to abandon all hope of combining forces with another entity. Some companies are opting for a "virtual merger." This is a relatively new strategy in which two businesses combine assets or operations yet retain at least some financial and managerial autonomy — similar to a joint venture or strategic partnership, but with a slightly different function.

Import gaining ground in U.S.

Virtual mergers are a European import. They only started taking place in the U.S. four years ago and remain relatively rare. Interest in virtual mergers is growing, however. In 2008, antivirus software makers CommVault Systems and McAfee combined strengths by integrating their product lines and cross-training their sales forces. Although the two companies retained financial and legal autonomy, their virtual merger helped them to compete with their common rival, Symantec.

When companies agree to a virtual merger, they sign contractual agreements that are functional — but not legal — equivalents to those of an actual merger. The two companies might, for example, contract to share a pool of assets; combine information technology or back-office support functions; consolidate product lines; or share commercial real estate holdings.

These can help the parties realize such traditional merger advantages as greater market share and cost synergies.

Ties that don't bind

Virtual merger agreements aren't necessarily legally binding. Although both parties sign operating service agreements, the companies remain legally independent, each with its own shareholders and directors. This can be an advantage when antitrust regulators object to an actual merger of market-dominating rivals. And because the arrangement isn't considered a legal merger, it can have tax advantages.

Virtual merger agreements typically allow either party to terminate the agreement after a specified time period or if agreed-upon revenues or cost savings benchmarks aren't met. In some cases, however, the party prematurely severing an agreement must pay a kind of breakup fee.

Looking long term

Virtual mergers serve several strategic functions: They help you reduce costs, increase efficiencies, raise market visibility and even gain access to your partner's best managers and employees.

Virtual mergers also can prepare your company to someday undertake an actual merger. Many companies in the past two years have been unable to merge because they can't find financing. A virtual merger can set the stage for a future merger by beginning the integration process now. A virtual merger may not be the best solution for companies that need to sell because their owners are retiring or they're trying to raise cash. On the other hand, if your company is seeking competitive advantages, cost savings, and growth, it's definitely worth considering. ■