PRAIRIE

THE VALUE OF AN M&A PROCESS

Why do many financial sponsors try to avoid buying companies in an M&A process?

Why do these same financial sponsors insist on selling their portfolio companies in an M&A process? What can be learned from this inconsistent behavior exhibited by these "professional" business owners?

Avoiding an M&A process and finding an acquisition target outside an auction provides the buyer with greater "input" on the purchase price and deal terms without the specter of competition. When a deal opportunity is outside an M&A process, the buyer can often assume that once the acquisition discussion reaches a certain point, "seller inertia" will set in and help the buyer drive the principal deal terms in their direction. Seller inertia occurs when a business owner becomes enamored with the concept of exiting the business and is reluctant to withdraw from deal discussions even when the price is reduced and/or deal terms become more favorable to the buyer.

When a deal is outside an M&A process, the seller does not have a "price discovery" mechanism to test the owner's valuation thesis. In addition, the seller does not start with a strong negotiating position to affect the other deal terms. A good negotiator might be able to partially mitigate the lack of deal term negotiating leverage but in the end, the terms will likely favor the buyer. Without competition, the business intrinsic value and other factors affecting the valuation will rely more on what value the seller is willing to accept for the business rather than a "market clearing" price and terms. Without an M&A process, the seller will always wonder what may have been left on the table.

When considering a company liquidity event, all business owners should consider the pros and cons of the type of M&A process they will employ. The counsel of a good advisory team, including an investment

Process Type	Process Description	Advantages	Disadvantages
One-on-One Negotiation	– Financial Advisor and the Company identify the best buyer. – Financial Advisor identifies the best transaction structure. – Financial Advisor approaches one prospective buyer. – Financial Advisor and the prospective buyer attempt to develop a mutually acceptable transaction. – All possible structures are exhausted before moving to another candidate.	– Minimizes dissemination of confidential and/or competitive information. – Minimizes disruption to operations. – Shortens process, if successful.	– May not realize “full” value as a result. – May exclude viable acquirers. – Can delay process in that the bidder may be able to dictate the speed of the transaction. – If fails, will require commencing broader process, with resulting loss of time and potential perception of “damaged goods.” – Lack of negotiating leverage may result in bidder successfully dictating the majority of terms.

banker and an M&A attorney, and a careful analysis of the seller’s goals and objectives will determine the type of M&A process that best fits with the specific situation. The tables throughout this paper provide a description of the three main M&A processes typically available to a seller.

No matter which M&A process is ultimately used, the advisory team should begin the engagement by determining the company’s primary value drivers, developing an estimate of the company’s valuation range and how the company could be positioned with potential buyers. The estimated valuation range is very important so the seller can establish a benchmark to judge potential offers.

One-on-One Negotiations

When secrecy is an important seller objective, a one-on-one M&A process or negotiation may be desirable. A one-on-one negotiation reduces the risk that proprietary information will be revealed outside of the process. Due to the smaller group involved in discussions, the source of leaked information will be obvious. The bench mark valuation range is particularly important in a one-on-one negotiation because it helps the seller quickly determine whether the buyer’s offer is in the relevant range and if a deal satisfactory to the seller is even possible. A one-on-one M&A process has more risk to the seller. Market deal terms may not be achieved in the negotiation, assuming the seller even has knowledge as to what the “market” is for the deal terms in its business. Also, by definition in a one-on-one process there is no alternative buyer so this approach, when compared to the other M&A process alternatives, has a lower probability of a successful closing. The use of a one-on-one M&A process should be very carefully evaluated and used only in limited circumstances.

Process Type	Process Description	Advantages	Disadvantages
Open Auction	− Approach many capable strategic and financial buyers and allow them to review the opportunity to develop strong transaction interest. − Public announcement that the Company is for sale. − Financial Advisor manages the bidding process.	− For well-known and high-quality companies, an auction maximizes value. − Keeps pressure on potential buyers and ensures timely responses.	− Will be most disruptive to business, management, and employees. − Will not be able to maintain full confidentiality of process. − Discloses competitive and/or confidential information to some low probability acquirers. − Some high probability strategic acquirers may decline to participate in large-scale auction. − Diminished image if no transaction occurs.

Competitive Process Alternatives

The alternative to a one-on-one negotiation is a well-orchestrated, competitive M&A process that provides significant benefits to a business seller. An M&A process is a mechanism to maximize the sales price, it provides an opportunity to obtain the best market deal terms and it increases the certainty of a timely and successful closing. In all types of sports, competition tends to bring out the best in the athletes. Buyer competition provides the same result in M&A transactions using Open and Controlled Auctions.

Open Auctions

An open auction has the highest probability of establishing a market clearing price and deal terms of the three M&A process alternatives. Publicly announcing that a business is for sale will likely attract the greatest number of interested parties. Furthermore all potential buyers are aware that they are in a broad competition and therefore must offer their best price and terms to win the deal. However, because of the "open" aspect of this type of sale, the company's customers, suppliers, competitors, employees and everybody else will know that the company is for sale. Generally, larger companies with significant brand value and a very broad potential buyer universe tend to benefit more from an open auction process. Few privately owned, middle market companies elect to use this M&A process because it can be very disruptive to the business.

Controlled Auctions

A controlled auction combines the market price and deal term "discovery" benefits of an open auction with a more controlled and limited dissemination of company information. A controlled auction begins with a careful selection of the buyer universe. Through direct communication these potential buyers are then screened by the investment banking team to determine

Process Type	Process Description	Advantages	Disadvantages
Controlled Auction	− Prepare memorandum and list of candidates to approach. − Financial Advisor approaches candidates without identifying Seller until confidentiality is assured. − Financial Advisor manages due diligence process of qualified buyer candidates. − Financial Advisor and Seller narrow down candidates based on value, terms, etc.	− No disclosure until deal is made. − Controls dissemination of confidential and/or competitive information. − Limits disruption to operations. − "Clears the market" with highest probability strategic/financial acquirers. − Allows healthy competition for the Seller. − Allows maximum flexibility.	− May limit the number of potential acquirers due to prioritizing process. − May not be able to maintain full confidentiality of process. − Slower than an open auction where a public announcement is made. − Chance of not including possible candidate.

their acquisition interests and ability to make a deal resulting in a screened list of qualified buyers. These qualified buyers are then exposed, first to limited company information and, once a nondisclosure agreement is obtained, more detailed information. Through a continuous process of questions and answers, satisfying additional buyer information needs and frequent follow up, a good investment banker will encourage strong buyer interest in a transaction. A tight, scheduled M&A process will impose milestones and deadlines on the buyers so that indications of interest in a transaction and later, a more detailed offer for the business are delivered by all the buyers at the same time so they can be compared and negotiated. A good M&A process allows an investment banker to signal the strength of competition in the M&A process and use this competition to "tease" out the best price and terms from the buyers. A good advisor will negotiate the major aspects of the deal before the seller commits to the buyer. Once the commitment is made, the seller gives up a large portion of its negotiating leverage. A well-orchestrated M&A process will provide the seller with alternative buyers and deal terms throughout the process so that the best possible price and deal terms "raises to the top."

Conclusion

Conducting a well-orchestrated M&A process requires strong analytical capabilities, a wealth of deal experience, well-honed negotiating skills and a thoroughly vetted plan. When looking at a sale of a business be sure you consider all of your M&A process alternatives. For most middle market business owners, a controlled auction will provide many of the benefits of an open auction without the risks associated with a one-on-one negotiation and the potential disruption by an open auction.

Finally make sure you are working with an advisory team, like Prairie Capital Advisors, with the skills and experience necessary to run a tight M&A process.

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