

ADVANCES IN MERGERS AND
ACQUISITIONS

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Finkelstein

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ADVANCES IN MERGERS AND
ACQUISITIONS VOLUME 20

ADVANCES IN MERGERS AND ACQUISITIONS

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INTRODUCTION

Cary L. Cooper and Sydney Finkelstein

This is the 20th Anniversary of our annual *Advances in Mergers and Acquisitions* series. And it is surprising to us the amount of new, innovative and insightful research and practice that has taken place in this last year, particularly during the pandemic and post-Covid era. But with the constellation of worldwide events of a pandemic, the global recession and world political events (e.g., Brexit, US elections, new regional trade alliances, etc.), many organizations are seeing real opportunities in merging, acquiring and partnering with others to get the added value during these difficult and challenging times.

We have eight outstanding chapters, from scholars and practitioners in a variety of countries exploring issues relevant to a post-Covid world and the ensuing recession. In the first chapter, by Andrew Sherman and Paul Pryzant, the authors highlight an M&A guidebook for a post-pandemic world, that is, creative in its ways to bridge the gaps between buyers and sellers post-Covid. The unpredictability of the global economy makes it more risky to consider acquisitions, very difficult to predict future earnings and, therefore, to put valuations on businesses. The authors explore why buyers and sellers want or don't want to do a deal in this environment, and all the issues associated with the post-Covid business world.

Chapter 2, by Konstantinos Bozos, Vassiliki Bamiatzi and Tamer Cavusgil, explores the role of organizational slack and acquisition experience in mitigating cross-border acquisition uncertainties. Given that cross-border acquisitions exceeded \$1.2 trillion in 2019, exploring the “black box” of cross-border acquisition success is very important and critical during the recession and beyond. Chapter 3 follows on highlighting the importance of ensuring acquisition completion after announcement, to ensure it is well managed. As the authors, David R. King, Wei Shi and Brian L. Connelly, suggest, it is vital that managers react to counter signals by shareholders, media, analysts and short sellers in terms of acquisition completion, that is, that external governance actors are instrumental for any successful merger or acquisition.

Fadi Alkaraan, the author of Chapter 4, highlights how Covid and the recession have made M&A investment decision-making a priority and toward an Industry 4.0 strategy. This means integrating all the technologies, supply chains and production processes – he highlights what this means for M&As in the future, and what research needs to be done. Mats Persson and Magnus Frostenson take this a bit further exploring the cultures of merging organizations, metaphorically as a “marriage.” They highlight three aspects of this metaphor: sequence of events, number of partners and power relations in this marriage. This will help to understand whether this relationship will work in the long run, and how it will function and develop.

Carlo Mari and Olimpia Meglio provide a very novel chapter in focusing in on “how customers experience an acquisition and whether merging firms perceive their customers as assets to trade or as stakeholder to engage.” They review the existing research into the customer-based experience of M&As, suggesting four research avenues for future studies. Moving from customers perspectives on M&As to employees, Benjamin Kempton and Riikka Sarala do a systematic and state-of-the-art literature review of the studies. Their primary aim is to understand the role of the employee in M&As. They examine five distinct research streams: employee reactions, culture, communications, knowledge and speed, highlighting the existing research foci and where research should go in the future.

And the final chapter in the book, by Emanuel Gomes, Sunbir Alam and Qile He, advocates the importance of the field of M&As from learning on the success and failures in strategic alliances. With such high failure rates in M&As, and the similarity in many regards between the issues experienced in strategic alliances, there is a need for each of these fields to learn from the other – research from both is highlighted to begin this process.

We would like to thank our contributors for their interesting and important contributions, and hope this will enable practitioners and researchers in their quest for enhancing the benefits of mergers and acquisitions and minimizing the downsides in the future.

CHAPTER 1

AN M&A GUIDEBOOK FOR A POST-PANDEMIC WORLD: CREATIVE WAYS TO BRIDGE THE GAPS BETWEEN BUYERS AND SELLERS AFTER THE COVID-19 PANDEMIC

Andrew J. Sherman and Paul Pryzant

ABSTRACT

In this chapter, the authors explore current trends in M&A deal structure, due diligence and post-closing challenges. The global pandemic has had a direct and indirect impact on the capital markets, transactions and market conditions, some short-lived and likely to return to normal as the global economy slowly re-opens and some more permanent as to how buyers and sellers and their advisors are likely to perceive, allocate and mitigate transactional risks.

Keywords: Capital market trends; mergers & acquisitions; deal structuring; due diligence; post-closing integration; allocation of risk

- The COVID-19 pandemic has caused a shift from a seller's market to a buyer's market in the space of a few months and has potentially forever changed the M&A deal process.
- How should deals can be structured to allocate the risks between buyers and sellers in a post-COVID-19 world?

The COVID-19 pandemic (COVID-19) throughout the course of 2020 and spilling into 2021 has created unparalleled uncertainty for nearly all businesses in

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that companies are unable to predict when and how businesses and consumers will resume buying their goods and services. This unpredictability has made it more difficult for dealmakers to use historical earnings to predict a company's future earnings, and accordingly their valuation, which has severely curtailed the number of M&A transactions at the present time. Somehow, however, a trickle of deals are getting done and others are being pursued, although at a much slower pace than in 2019 but many predict that M&A at all levels and most industries will come roaring back by Q2 of 2021.

WHY WOULD BUYERS AND SELLERS WANT TO DO A DEAL IN THIS ENVIRONMENT?

Buyers with available funds may find that the current environment provides opportunities that would not have existed before the pandemic. In particular, strategic buyers with deep industry expertise will look for transactions that will allow them to add a new product or service, acquire new technology or a set of skilled employees or some combination thereof. Private equity buyers have a lot of available funds to invest and will need to deploy capital, especially if they perceive this to be a buyer's market. One of the pandemic's principle effects for M&A transactions has been to lower seller valuation expectations, motivating sellers to be more flexible than they were only a few short months ago. As a result, valuation expectations are materially lower for sellers, making it easier to structure a transaction that makes sense for both parties. In certain industries, such as hospitality, travel, tourism and restaurants, opportunities in troubled, turnaround and even bankrupt companies have led to very attractive valuations.

Throughout this chapter, reference to "private equity" generally means platform acquisitions by a private equity fund, which are acquired to be a standalone portfolio company, as opposed to a "tuck-in" acquisition by a portfolio company. "Strategic buyer" generally means an existing company already operating in an industry, which can include both public and private companies and can include a private equity portfolio company looking for a tuck-in acquisition.

Many young start-ups and technology companies may lack sufficient cash resources to weather the COVID-19 storm and may be unable to find additional funding quickly enough. This predicament may increase the attractiveness of a larger strategic buyer capable of providing stability and added resources that the seller and its employees sorely need. Sellers may have other reasons to seek a sale, including the death or divorce of a founder, the need for liquidity to provide some diversification for the owners or a management team that has reached its limits for moving the company forward. In some cases, COVID-19 has "expedited" the retirement plans of baby-boomer business owners who have re-prioritized their life goals. Such sellers may have been trying to find a buyer before COVID-19 and do not have the luxury of waiting a year or longer for a more favorable selling environment. There are also distressed situations in which a company may face insolvency and bankruptcy, but transactions involving bankruptcy have very different rules and considerations which are beyond the scope of this chapter.

What Trends Have Influenced M&A During the Pandemic

If there is anything that is certain for M&A in 2021 and beyond, it is uncertainty. In a Fall of 2020 McKinsey survey of global leaders, 80% of CEO's said that they do not believe that their current business models were sustainable, due to the impact of COVID-19, digitization, shifting work place trends and the overall impact of technology. How will M&A be impacted? How will M&A be part of the solution and not just make the problem worse? Many experts predicted that COVID-19 expedited the path to digitization by as much as five to seven years and most companies were just not ready.

In addition, the impact of the new Biden Administration on capital gains/estate/income taxes, health care, immigration, trade and foreign relations, environmental policy is all uncertain. As the submission of this chapter to the publisher, the balance of power in the US Senate was still unclear.

HOW HAS DUE DILIGENCE AND THE M&A PROCESS CHANGED IN THE POST-COVID-19 ENVIRONMENT?

Acquisitions typically are the start of a long-term relationship between the seller's management team and the buyer, the success of which depends heavily on the seller's key employees. For buyers, face-to-face meetings with the seller's management team remain a critical component of deal-making and due diligence, and few buyers will be willing to close a transaction without several opportunities to interact in person with the management team. Most deals that eventually closed in 2020 were likely underway before the pandemic, so the buyer already had spent time with the seller and the seller's management team. Due to the challenges posed on travel by COVID-19, the nature of due diligence on the management team is likely to change. For new transactions in which the buyer has no prior relationship with the seller, video conferences will allow the sale process to get started between motivated parties. For now, however, buyers will likely insist on meeting the management team in person before they are willing to close the deal.

Travel has been constrained for an extended period which together with immigration restrictions affecting cross-border transactions, buyers may need to rethink their dependence on face-to-face meetings. Similar to hiring decisions, buyers will become more comfortable sooner or later with video conferencing, both for getting to know the management team during due diligence and for interacting with them post-closing. Buyers may also increase their use of personality tests and similar assessment tools to better understand the management teams of the seller during due diligence. You can also expect to see buyers becoming more structured in their due diligence discussions on video conferences, similar to the hiring methodology Geoff Smart and Randy Street recommend in their book, *Who—The A Method for Hiring*. Although right now partners at private equity funds and strategic buyers may say that they would never buy a company without extensive meetings with the management team in person, this attitude could change if the effects of the pandemic persist.

The inability to meet with the seller's management in person is one of several reasons to extend the due diligence time period. An extended due diligence period

allows the buyer more time to assess more accurately COVID-19's impact on the seller and to find any needed financing for the deal. As a result, look for the exclusivity period in letters of intent to be extended from the typical period of 60 days pre-COVID-19 to 90 or 120 days, if not longer.

Due Diligence and the Nature of the Seller's Assets

A few short decades ago, most of the assets conveyed especially in middle-market M&A deals were tangible in nature, such as equipment, inventory, real estate, vehicles, etc., but most transactions in 2021 and beyond will be the exact opposite. Today's most critical strategic assets include brands, relationship, channels, culture, reputation, systems, processes and social media and digital assets.

The skill sets and experts needed to satisfy due diligence best practices in the 2020s, together with the impact on allocation of risk that R&W insurance policies have created, will permanently change the nature, scope, depth and breadth of due diligence.

The exact nature of due diligence will strongly depend on whether the key assets of the seller are intellectual property, such as for a software company, or whether the key assets are physical, such as inventory or a factory or distribution facility. The more the key assets are physical, the more likely the buyer (and the buyer's lenders) will require physical inspections that will lengthen the closing timetable.

Certain physical assets, such as a factory or distribution facility, will require more rigid due diligence on new health and safety measures put into place to protect workers at the facility. Similar to having Phase I environmental reports for real property, third-party health and safety inspections must be added to due diligence checklists for physical facilities.

The pandemic provides new lines of questions to ask the management team to better assess its capabilities and the operations of the target business.

- What decisions did you make to cope with the pandemic and why? How did they turn out? How did you treat your employees and vendors? What did you learn, and what would you do differently? How has work place and work space shifts affected leadership, governance, teamwork, collaboration and innovation? New product development pipelines? How has it affected culture or exacerbated already alarming levels of disengagement? (See Gallup Study on the *State of the American Workplace*.)
- What is the seller's supply chain vulnerability, especially to China and other overseas sources? What plans does management have to change the supply chain in a post-COVID-19 world?
- What additional operating costs are required to operate in a post-COVID-19 world?
- How has management adjusted to the Fall 2020 spikes in the spread of the pandemic?

A common area of due diligence in 2020 was targeted at a loan under the Paycheck Protection Program (PPP) and Economic Injury Disaster Loans

(EIDL) programs, especially if the loan was for more than \$2.0 million so that it is subject to the automatic audit promised by the Small Business Administration (SBA). Buyers should ask about the seller's eligibility for a PPP loan under the SBA's affiliation rules. Buyers will be leery about buying a company subject to an SBA audit when the seller's eligibility was questionable, or there are questions regarding the seller's good-faith certification regarding the "necessity" of the loan and its eligibility for loan forgiveness.

Due to the shift from a seller's market to a buyer's market, sellers must find ways to distinguish themselves in a chaotic marketplace. One way to do that is to make due diligence easier and more transparent for the buyer. In this new environment, sellers should make the up-front investment in pre-sale due diligence. This will include investing in a more thorough quality of earnings (Q of E) review before starting the sale process. The Q of E will provide the buyer with better visibility into the seller's pre-COVID-19 financial performance and how the seller will manage through the disruptions caused by the pandemic. A seller will also want to prepare a "stress test" analysis for its business under different possible scenarios in a post-COVID-19 world. Buyers will find sellers with more transparent financial data and a plan for an uncertain future to be much more attractive. These types of "stress test" analyses are critical to help develop more creative deal structures required under the current environment, as discussed below.

How ESG and CSR Priorities Have Crept into the Due Diligence Process

As corporate strategy and the capital markets embrace Environmental/Social/Governance (ESG), Corporate Social Responsibility (CSR) and impact investing priorities, ESG-driven issues have crept their way into M&A and that trend is likely to continue in 2021 and beyond. Our recent political, social and economic unrest and divisiveness have lead buyers to make ESG priorities a critical screen and filter in due diligence, provisions in definitive documents and post-closing conditions and covenants. An increased emphasis on environmental compliance and carbon footprint, worker safety and hygiene, child labor and supply chain, diversity and inclusion, governance best practices, digital asset brand and reputation are all likely to affect M&A transactions and definitive documents.

What Are Ways to Bridge the Valuation Gap, Given the Uncertainty in the Seller's Future Financial Performance?

Setting the Stage – Valuation Methodologies and Changing Expectations

Three common ways to value target companies are:

- Multiple of prior 12 months of Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA), which is used for companies with earnings. This is the most common valuation methodology.
- Multiple of revenues, most commonly used for software and other technology companies that have been able to build significant sales but are not at the stage of having earnings.

- A “build versus buy” analysis, in which the buyer assesses the cost to duplicate the functionality of the seller’s product or technology from scratch, versus the cost to buy the seller and its employee team. This measure is most commonly used for early-stage software and other technology companies prior to them having significant sales revenues. Acquisitions of these types of companies are especially attractive if they have a skilled set of employees who can jump-start the buyer’s efforts to add a new product or service or technology. This valuation methodology generally leads to lower valuations, but not always, depending on the immediate needs of the buyer. When Facebook paid \$1 billion for Instagram in 2012 for a one-year-old company with 13 employees, it sounded insanely high at the time, but in retrospect, it has turned out to be a bargain and has been recently valued internally as an asset works in excess of \$100 billion.

A seller’s historical earnings are no longer a predictable measure of future performance due to the uncertainty caused by COVID-19. Before the pandemic, in a seller’s market, the multiples of EBITDA and revenue used to value sellers were at all-time highs, with auctions attracting a large number of potential buyers. Using trailing 12 months (TTM) of EBITDA or TTM of revenues were reasonable ways for buyers to predict future financial performance. COVID-19, however, has upended these metrics as a way to value companies. How do you value a company after COVID-19 when you cannot predict with any certainty how a company will perform over the next 12–18 months? For the “build versus buy” valuation analysis, the changed environment probably will not materially change the buyer’s analysis, but it has substantially changed the seller’s expectations, making them more receptive to an acquisition.

One big difference between the current environment and prior recessions, such as the recession of 2008–2009, is that sellers have quickly grasped the uncertainty caused by the pandemic. In prior recessions, it took 12–18 months for sellers to fully understand the new reality. Today, sellers’ expectations have reset almost immediately. Sellers that have the staying power and resources to wait may be content to do so until conditions improve. Sellers that have other pressures may be more motivated to sell, notwithstanding the current uncertainty, and more willing to share the risks with the buyer. From the buyer’s perspective, and especially for strategic buyers, if a target company is a strategic fit that provides a new product or service, or a new technology or skilled group of employees, this may be an excellent time to make an acquisition. If both the buyer and seller are motivated and are willing to be more flexible than before the pandemic, then deals can still happen.

How do you bridge the valuation gap to deal with the uncertainty caused by COVID-19? The answer is to creatively allocate the uncertainty risk between buyer and seller. The tools to do this can differ for private equity and strategic buyers.

Tools to Bridge the Valuation Gap

1. Reduced Total Purchase Price and Reduced Cash at Closing.

Companies that are valued as a multiple of earnings or revenues are not worth as much today as they were in early 2020 in the pre-COVID-19 world. Particularly

attractive companies that were in auction processes in early 2020 with multiple bidders may have received bids of $10\times$ 2019 EBITDA, with 90% or more of the purchase price paid in cash at closing. In the current environment, however, a more realistic multiple might be $8\times$ or $9\times$ 2019 EBITDA, with only 50–60% of the purchase price paid in cash at closing. The remaining portion of the purchase price will be contingent, deferred or subject to an equity rollover, using some of the tools laid out in more detail below.

2. *Earn-outs.*

Earn-outs are a tool that can be used by both private equity and strategic buyers. According to the 2020 M&A Deal Terms Study by SRS Acquiom (the SRS study), which analyzed 1,200+ private-target acquisitions from 2015 to 2019 (i.e., the pre-COVID-19 period), earn-outs for non-life-science deals were used in an average of approximately 18% of transactions over the past four years, as shown in the chart below. Given that earn-outs are used more frequently in life-science transactions, the SRS Study excluded those transactions to get a better measure of how earn-outs are used outside of life-science transactions. For transactions with earn-outs, the metrics used were revenues, EBITDA and other milestones (such as unit sales or product launches), or sometimes combinations of these metrics, depending upon the business and the stage of development of the target company.

According to the SRS study, in non-life-science transactions with earn-outs, the earn-out potential as a percentage of the closing payment generally hovered around 40%, and the length of the earn-out period ranged from less than one year to more than five years, with a median of 24 months.

Before COVID-19, both buyers and sellers were wary of using earn-outs. Earn-outs have often half-jokingly been referred to as “litigation magnets” because disputes regarding whether the earn-out has been achieved are common. Some of the reasons for the disputes have been due to ambiguous metrics for determining whether the earn-out has been met, changes in the buyer’s operations post-closing, the allocation of expenses and the difficulty caused by changing circumstances, especially when the earn-out period is long (more than two years). As a result, before COVID-19, earn-outs were imperfect tools that were used only when absolutely necessary to bridge the valuation gap between buyer and seller.

After COVID-19 is behind us, hopefully by Q3 of 2021, however, earn-outs will become increasingly popular to allocate more risk to the seller for the uncertainty of future performance. As a result, these are likely changes for earn-outs:

- Earn-outs will be used in a higher percentage of transactions, from the current 18% to perhaps 30–40% of deals, or higher.
- The time period for earn-outs will increase from the current median of 24 months to longer timeframes. Given the uncertainty with how long it will take for companies to recover from COVID-19, most companies have no visibility into what their results will be for 2020, and even into 2021. Therefore, earn-out periods may extend into 2022, 2023 and longer to give the seller more opportunity to achieve the earn-out.
- The earn-out potential as a percentage of the closing payment can be expected to increase from the current 40–50% or higher.

3. *Equity Rollovers.*

Equity rollovers are a tool used almost exclusively by private equity buyers in platform acquisitions, and sometimes for tuck-in acquisitions. Equity rollover transactions typically involve rollover participants taking between 10% and 40% of the purchase price in the form of equity in the buyer. Equity rollovers are generally restricted to founders and other members of the seller's management team who are joining the buyer post-closing. This provides founders and management with a meaningful equity stake in the buyer to align their respective interests to grow and sell the target company. Generally, existing equity holders in the seller who are not founders or part of the management team (i.e., venture capital, private equity or angel investors) are excluded from the equity rollover, because they have no ongoing role with the buyer post-closing and would rather exit the investment in the seller. Private equity buyers also like equity rollovers, because they serve as a form of seller financing that reduces the buyer's up-front cash payments at closing.

Equity rollovers were already very common before COVID-19. In the future, they will likely be used as a tool to allocate more risk to the seller to deal with the unpredictability of post-COVID-19 financial performance. Below are some of the changes we are likely to see.

- The equity rollover percentage is likely to increase. Prior to the pandemic, a private equity buyer might have been agreeable to only a 10% or 20% rollover by the founders and management team. In the post-COVID-19 world, the equity rollover percentage will likely increase to 30% or 40% as a means of shifting more of the risk to the seller and decreasing the need for outside financing.
- The seller participants in the equity rollover are likely to expand to include more of the equity holders in addition to the founders and management team. The buyer may insist on having venture capital, private equity or angel investors included in the equity rollover. This may not be ideal for those investors who may have wanted to completely exit their investment, but they may have no choice in the current environment. For the buyer, this shifts the post-COVID-19 risk to more of the seller's equity holders and increases the amount of seller financing.
- The private equity buyer may insist on having a liquidation preference for its equity, which will be paid out prior to the equity rollover received by the seller participants. Before COVID-19, it was typical for the seller participants to receive rollover equity with the same economic rights and preferences as the private equity buyer. In the current environment, however, private equity buyers are more likely to insist on receiving a $1\times$ liquidation preference, or a $1\times$ plus a return of some amount (i.e., 8%), to provide downside protection to the buyer. The buyer will argue that the seller participants have already cashed out a significant portion of their investment, so it is only fair for the buyer to be protected if the post-COVID-19 performance of the seller is significantly worse than expected.