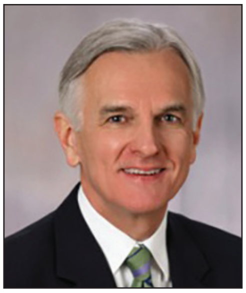

The Seven Phases of M&A

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With 18 successful deals concluded over the past 18 months, M&A activity in the orthopaedic industry is sizzling. Given healthy balance sheets and cheap debt, large and mid-sized buyers are well positioned to aggressively pursue acquisition opportunities in 2015 and beyond.

CEOs looking to sell their companies within the next 12 to 18 months should be mindful of how strategic buyers manage deals, including each of the steps in a typical buy-side transaction lifecycle. The CEO who understands and prepares for the process can potentially speed the completion of a buyer's due diligence, increase the certainty of a close, optimize the price by minimizing risks and maximizing value and sell the business when and to whom they prefer—with greater confidence and less frustration.

This article highlights the typical process of buying a company, with specific context for buyers and sellers who may be new to the process or are interested in picking up a few tips.

The Buyer's Perspective

For a prospective acquirer, the success of a typical M&A transaction is a direct result of the buyer's expertise in identifying, analyzing, and executing the deal—and then integrating the new company post-close. Many experienced acquirers in the orthopaedic industry have developed a disciplined and repeatable M&A process, one that they consistently rely upon to identify, negotiate and conclude deals.

The M&A transaction process utilized by large and mid-size companies typically comprises the following seven phases:

Phase I: Develop a Strategy that Complements the Strategic Business Plan

Acquisition strategies derive from a company's strategic business plan. Senior leaders at orthopaedic companies typically view M&A as a tactic to *execute* their strategy—not as the strategy itself. As a result, these companies usually have a clear and well-defined strategic business plan that may then be partly or fully enabled through organic growth, partnering, licensing or M&A.

If a company decides to enter a new area by adding products, services or manufacturing to an existing business via a transaction, an acquisition strategy—consistent with the strategic business plan—is developed and many of the following areas addressed:

- Establishing the core objectives
- Identifying target products and technologies
- Confirming geographical focus and market opportunity
- Identifying critical success factors
- Developing target selection criteria

However, even with a well-thought-out strategic business plan, many acquisition opportunities are presented to strategic buyers without warning and typically require quick evaluation. Senior managers and business development executives on the buy-side try to think strategically, but may frequently need to react opportunistically. Buyers simply can't time when companies or assets will be offered for sale.

Phase II: Assess Options

Strategic buyers are constantly "casting-the-net" for potential opportunities. They utilize senior executives and business development, sales, R&D, technical personnel and industry consultants to identify value-added technologies, products and companies.

Acquirers utilize quantitative and qualitative data to "rank" opportunities based on market, technology and financial criteria. Frequent buyers increasingly are using other tools to effectively manage the entire M&A process, including negotiations, due diligence, valuation, risk assessment and integration.

Many larger strategic buyers may consider between 50 to several hundred buy-side opportunities, annually. They may more critically examine about 25 percent of those opportunities and successfully conclude between four to 12 transactions per annum. Assessing a large volume of opportunities allows a potential buyer to understand the strategic possibilities that exist—and at what price points—and determine the value of each opportunity relative to the others. In addition, it forces senior management to bring discipline and speed to the screening process.

Phase III: Engage Targets

The third phase of the transaction process is the engaging of potential acquisition targets. A buyer's primary objective is to pre-qualify an acquisition target as a potential strategic fit, and as being reasonably likely, willing and able to successfully conclude a transaction.

Initial discussions can take place in a variety of ways—through a structured process (usually involving an investment banker) or conversations among executives at an industry meeting, or simply a cold-call. Follow-up discussions (conference call, face-to-face meetings) usually involve a larger group of executives—and inevitably force an important question to be answered by the buying and selling companies— that is, is the potential for a deal sufficient to justify a further investment of resources? If yes, the process moves forward. If not, both companies may simply agree to remain in touch; opportunities are many times "resurrected" in the future.

Assuming the process moves forward, both parties will likely sign a non-disclosure (or confidentiality) agreement, get friendly, learn as much as they can about each other's wants/needs and attempt to gain momentum around business possibilities.

Experienced acquirers will use the early negotiation period to foster a sense that both parties are working together in good faith to arrive at a mutually advantageous transaction. Building relationships—and "relationship capital"— early on is important, since it is usually needed in the later stages of the deal.

For the buyer, the biggest benefit in directly reaching out to the seller lies in discussing potential transaction opportunities without the seller necessarily being actively engaged in "shopping" the company. The opportunity may exist to acquire the target outside of a competitive bidding situation, which may partially mitigate the risk of overpaying for the business as well as being forced to keep pace with other potential buyers in a formal, managed sale process.

For the seller, the biggest benefit of having a buyer reach out directly is a potentially shortened—and more discreet—transaction process, which may include minimal risk of "sensitive information" being leaked to the market. A challenge to this approach, however, is that the seller may lack negotiating leverage and lose the ability to maximize value, since there are no other buyers actively competing for the business.

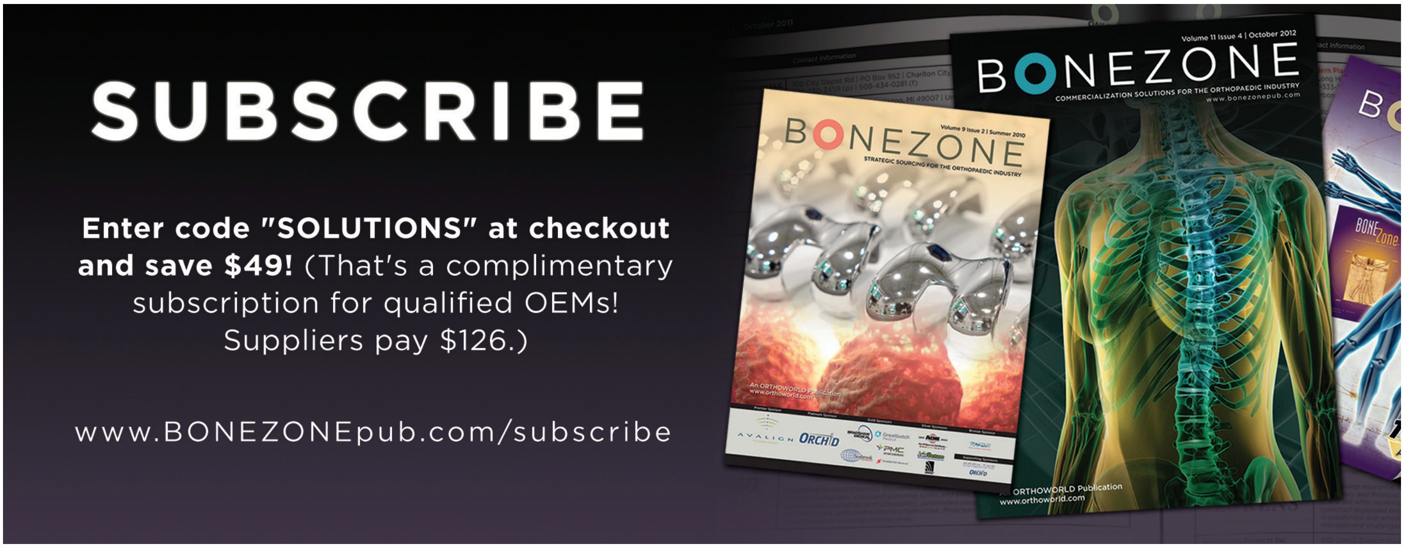
Phase IV: Evaluate the Transaction and Reach Initial Agreement

Although neither party has sufficient information to make price an absolute focus, some "feeling out" and discussion about deal structure and price range is required. The executives representing both parties should remain flexible—and respectful—during their discussions and look to further understand and appreciate each other's positions.

During this phase, the prospective acquirer will likely build an initial financial model, including projected sales, profit and cash flow to establish a baseline valuation for the opportunity.

Two methods used in conjunction to assess value include:

- Discounted Cash Flow: An income-based valuation technique in which the value of a company is estimated based on the present value of its expected future economic benefits (i.e., free cash flow), and



- Precedent M&A transactions: A market-based approach that focuses on examining the terms, prices and conditions found in the sales of companies, for example, in the orthopaedic industry. After current, relevant transactions are identified, transaction valuation multiples of enterprise value, revenue and/or EBITDA are applied to the corresponding operating results of the target company to estimate its implied value.

To establish a value range, a buyer will also include synergies, other cost saving benefits and revenue-enhancing opportunities as well as dis-synergies and costs required to mitigate any risk.

All buyers have financial metrics that they adhere to for various deal types. Some examples include: cumulative sales over a five-year timeframe, internal rate of return (IRR) of operating cash flow and, for publicly-traded companies, whether the deal is accretive or dilutive to earnings per share.

The seller may also consider building a financial model and attempt to put himself in the shoes of the acquirer by making realistic modeling assumptions. In this way, the seller can anticipate the buyer's potential valuation ranges via best, base and worst case scenarios and be in a stronger position to challenge the buyer's valuation assumptions.

If the deal is strategically and financially desirable, the acquirer will submit a non-binding form of interest, such as an indication of interest (IOI) to the seller.

Once the buyer and seller agree on all preliminary IOI terms, the process moves forward. If not, both sides should part amicably and continue to respect the NDA in place since it's likely their paths will cross again in the future.

One typical question from a seller is: When should an IOI be requested, before or after due diligence? There is no right or wrong answer. However, sellers should understand that when talking with more sophisticated or larger buyers, submission of the IOI until *after* due diligence is completed may not be negotiable, depending upon the acquirer's internal process. Either way, the expectation regarding IOI submission should be addressed, understood and agreed upon (if possible) by both sides at the earliest stages of the process.

Typically, a buyer will want to conduct as much due diligence as possible before submitting an IOI. Assuming no "walk-away issues" are identified, a buyer would argue that they will be in an optimal position to more accurately address valuation and final deal structure (including any milestones and/or royalties) post-due diligence.

On the other hand, the seller will typically request an IOI before investing what he perceives to be a significant amount of time and expense during due diligence. However, the seller should keep in mind that if a buyer submits an IOI prior to due diligence and then identifies material issues during this step of the process, the buyer will "request" that the IOI be renegotiated, a situation that could potentially reduce valuation and/or derail the transaction.

In an effort to reach a middle ground, the seller should be prepared to share some preliminary due diligence information with the buyer. The gesture will likely have a positive impact on establishing the "relationship capital" referred to earlier.

Phase V: Conduct Due Diligence

Due diligence transitions the process from the high romance of partnership to the mundane world of fact checking and validation.

Buyers use due diligence to better understand the target and its investment merits, improve their integration prospects, identify any deal-breaking issues prior to committing additional time, resources and expenses in exploring an acquisition and to finalize financial expectations.

Acquirers also use due diligence to deepen their knowledge about—and links with—the seller's management team. Every such interaction offers the acquirer an opportunity to assess the selling team's abilities and better understand each person's aspirations.

Many acquirers organize due diligence teams functionally, working off checklists. Others have found that decision-making flexibility and process efficiency can be enhanced by organizing around issues. Some have incorporated increasingly sophisticated analytic tools into the process to help navigate and mitigate risk. Experienced teams can differentiate between "must haves" versus "nice to haves" and have built competitive advantage through past successes and failures.

Sellers should be well-prepared for the due diligence items that frequently uncover risks, including (in no particular order): financial records and controls, internal and external agreements (including those with healthcare professionals), IP, litigation, employee-related issues, compliance and quality systems.

One thing that buyers and sellers usually agree upon is, a potential transaction that ends at the due diligence stage almost always ends for the right reasons.

Phase VI: Negotiate Final Terms and Achieve Closure

This phase may be the most sensitive, since the buyer may seek to renegotiate price if material risks/issues are identified during due diligence. The experienced acquirer will come to the table with a short list of the most important issues negatively impacting valuation, and attempt to resolve each in order of priority.

Once both sides reach agreement on economics, the buyer will typically send the seller a more detailed draft Definitive Agreement, examples of which could be a Stock Purchase or Asset Purchase Agreement. The Definitive Agreement represents the definitive statement of the deal's terms and conditions and generally includes Transaction Terms, Representations and Warranties, Covenants, Indemnifications and Conditions To Closing of/by the buyer and seller. Negotiating the draft agreement will require additional time, effort and patience.

Throughout the process (at least prior to any exclusive negotiations), experienced buyers may be carrying on a dialogue with alternative targets. Likewise, savvy sellers may be discussing transaction opportunities with other interested buyers. Either side's deal team behaves more confidently when it knows it has a choice, and that confidence usually gets projected across the table during negotiations.

Once the final economics and details of the draft agreement are fully negotiated and agreed, the Definitive Agreement is signed by both parties and the transaction becomes "official."

Phase VII: Integration

The final phase of the M&A transaction process is integration, bringing together the buyer's and the seller's employees, customers, distribution channels, technology, products and manufacturing capabilities post-closing in an effort to create tangible value for the buyer.

Many buyers have established a formal structure for integration, such as an integration officer or team, to manage the process. Typical integration goals may include:

- Identification of a set of common operating principles and procedures for all key functional areas
- Determining and building critical infrastructure capabilities (i.e., IT)
- Developing a detailed road map that marries integration and business objectives to ensure that strategic and financial objectives are achieved
- Building "one company with one culture" and communicating a common vision for the future

An integration plan usually focuses on the "first 100 days post-closing" and is put in place by the buyer in the very early stages of the process and refined throughout the process. The buyer's objective will be to seamlessly integrate the newly acquired business, which can take up to 12 months to complete.

During integration, buyers continually assess ongoing growth alternatives and priorities, conduct portfolio rationalization and critically review threats to the sustainability of the business model.

Don Urbanowicz is Principal of Urbanowicz Consulting (UC), an advisory firm with a musculoskeletal focus seeking to enable clients to achieve strategic and transaction-related goals by capitalizing on market opportunities. UC offers a unique perspective on how large global companies approach strategy, valuation, negotiations, due diligence and integration, and a thorough understanding of achieving success throughout all phases of the transaction process. He can be reached at durbanowicz@du-llc.com.

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Additional Points for a Seller to Consider

Be prepared early on. Conduct a due diligence review of your company, clean up potential issues a buyer may have with your business and consider what an optimal outcome will look like.

Identify a target list of buyers and monitor their deal activity to learn their strategic priorities. This allows you to determine where you "fit", if at all.

Know your prospective partners. Conduct due diligence on each potential buyer. Don't be afraid to ask them the same tough questions they're preparing to ask you. Learn about your prospective buyer's portfolios and portfolio gaps from their websites and SEC filings.

Prepare your web-based data room in a timely manner—it takes longer than you think, and most sellers are only partially prepared when buyers formally initiate their due diligence process.

Review what you share. Buyers will review your financials, IP and quality/manufacturing processes. Get comfortable with each issue and opportunity.

Be patient, but not too patient. The transaction processes utilized by strategic and financial buyers is disciplined, deliberate and formal—it could take up to six months to successfully conclude a transaction in a best case scenario, six to 12 months in a base case scenario, and 12 to 18 months in a worst case scenario. That said, time is your enemy. The price and terms usually get worse as a deal drags on, and the risk of the deal blowing up increases.

Focus on running the business. Transactions can be a time-consuming distraction for the seller's leadership team. Missing sales projections during the process can negatively impact valuation and/or slow the process down.

Don't think you can manage the process yourself. M&A requires optimizing sales price valuation, structuring the selling process and managing potential buyers requires deal instinct and experience. Get help from a professional with a positive reputation with buyers.

Additional Points for a Buyer to Consider

Keep a strategic focus. Try not to fall in love with a one-off opportunity. Once that happens, financial modeling assumptions get "stretched" to make the transaction work.

Set expectations early. Inform the prospective seller about your transaction process, including process steps and corresponding timeframes, early on. Transparent communication up front will eliminate (or at least reduce) seller frustration as the process evolves.

Build relationships with potential partners. Deals are made between people. The best acquirers focus on developing relationships with sellers.

Escalate material due diligence issues. These will negatively impact valuation. Handle major issues early, because terms become less flexible as the process gathers momentum.

Appoint a transaction leader. Ensure you have a clear transaction leader and a core team of individuals (who have preferably worked together) who are involved with the transaction from the early discussions, through due diligence and integration planning to deal closing.

Analyze value and risk. This is of paramount importance; be diligent in measuring results and remaining accountable.