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[How Successful Buyers Manage Their Deals; Insights Into The Process]

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CEO's looking to sell their companies should be mindful of how strategic and financial buyers manage deals — and initiate their own planning processes to be prepared.

Introduction

M&A activity is expected to remain strong over the next several years. Select orthopedic device companies have very healthy balance sheets. Persistent revenue headwinds and underwhelming innovation will continue to force strategic's to acquire in order to generate incremental revenue to offset the medical device tax and/or continue to deliver value to shareholders. In addition, financial buyers, many flush with cash, may also seek acquisitions in the orthopedic sector.

These experienced strategic and financial buyers will typically approach potential orthopedic acquisition opportunities with a well-established process. I've described below how successful buyers manage their deals with a disciplined process. The five steps in a typical transaction life-cycle process utilized by strategic and financial buyers includes:

- Assessing Options
- Evaluating The Transaction and Reaching Initial Agreement
- Conducting Due Diligence
- Negotiating Final Terms And Achieving Closure
- Integration (and Learning From The Experience)

Assessing Options

Acquisition opportunities are frequently presented to strategic and/or financial buyers without warning and typically need to be evaluated quickly. Senior managers and business development executives on the buy-side try to think strategically – but frequently need to react opportunistically.

The better strategic and financial buyers are constantly "casting-the-net" for potential opportunities – and utilize their senior executives and business development, sales, R&D, and technical personnel and outside consultants to identify value-added technologies, products and companies. Many larger strategic or financial buyers may consider between 50 to 500 opportunities annually. They may closely examine about 10-15% of those opportunities and successfully conclude 4 to 6 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 managers to bring discipline and speed (hopefully) to the screening process.

Evaluating The Transaction and Reaching Initial Agreement

Initial discussions can take place in a variety of ways – through a structured process or conversations between executives at an industry meeting or simply a cold-call. Follow-up discussions (conference call, face-to-face meeting) usually involve a larger group of executives – and inevitably force an important question to be answered by the buying and selling companies – 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 sometimes "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 others wants/needs and attempt to gain momentum around business possibilities. It's natural for the seller to feel nervous and possibly suspicious about the potential buyer. Experienced acquirers will use the early negotiation period to foster a sense of trust 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.

Although neither party has sufficient information to make the transaction 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 potential acquirer will build a valuation model that will include sales, profit and cash-flow projections based on assumptions regarding "value-drivers", synergies and dis-synergies and integration-related issues and opportunities. If the deal is strategically and financially desirable, the acquirer will submit an indication of interest (IOI) to the seller. This IOI — which may be non-binding or binding — will usually include information regarding the buyer's:

- Preliminary valuation (or valuation range)
- Due diligence and timing
- Conditions and approvals (who from acquiring organization needs to provide final approval)
- Financing (how acquirer intends to pay)
- Outline of contract terms (draft agreement would typically include agreed upon representations, warranties, covenants and indemnification provisions)

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 and NDA's put into place since their paths may 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. The expectation regarding IOI submission should be addressed and agreed (if possible) by both sides at the earliest stages of the process – keeping in mind that some “balance” will be required as the process evolves.

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 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 likely present a revised offer, a situation that could potentially derail the transaction.

Conducting Due Diligence

Due diligence is the most time consuming and probably least creative part of the transaction process. Here the process transitions from the high romance of partnership to the mundane world of fact checking and validation. Buyers use due diligence to minimize risk exposure, improve their integration prospects and finalize financial expectations.

Typically, the due diligence process includes an analysis of the seller’s financials (audited is typically preferred), legal history, business activities, and customers and focuses on identifying:

- Potential threats related to the acquisition
- Risks that need to be eliminated or mitigated
- Synergies and non-synergies
- Significant findings influencing the valuation and, potentially, the deal structure

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 teams abilities and personal agendas.

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 health care professionals), IP, litigation, employee-related issues, compliance and quality systems.

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

Negotiating Final Terms And Achieving Closure

This phase may be the most sensitive since the buyer may seek to renegotiate price if material risks 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 Agreement, examples of which could be a Stock Purchase or Asset Purchase Agreement. This Agreement generally includes: Transaction Terms, Representations and Warranties, Covenants, Indemnification, and Conditions of/by the buyer and seller. Negotiating the draft agreement will require additional time, effort and patience.

Many buyers take the view that their company needs to speak with “one clear voice” at the negotiating table and limit the negotiations to one individual or a small team of key people. Others may divide the deal team into two (or more) negotiating groups, for example, business leaders and lawyers. This division of labor allows for parallel processing; it also allows for one group to deliver tough messages or to remain firm on select negotiating positions while the other group uses some of its “relationship capital” to maintain momentum during the discussions.

Some financial and strategic buyers have a policy of not participating in competitive auctions – the feeling is that the winning party may overpay. In addition, strategic and financial acquirers will likely insist that once an IOI is agreed, future conversations be carried out on an exclusive basis. Sellers – keep in mind that serious buyers will almost ALWAYS participate and remain in an auction process.

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 draft agreement are fully negotiated and agreed, a Definitive Agreement is signed by both parties and the transaction becomes “official”.

Integration (and Learning From Your Experience)

Integration is the process of bringing together the buyer’s and the seller’s employees, customers, distribution channels, technology and products, and manufacturing capabilities. An integration plan – developed to focus the buyer’s efforts on the goals of the acquisition — is usually put in place by the buyer in the early stages of the process and refined throughout the process. Depending on deal structure, the buyer prefers to be in the driver’s seat when seeking integration guidance from the seller’s key people. The buyer’s objective will be to seamlessly integrate the newly acquired business – which can take up to 12 months.

All too often, the expensive lessons that acquirers and sellers learn are forgotten once the deal is concluded – successfully or unsuccessfully. Each transaction opportunity should be treated as a learning experience and a post-mortem conducted within 30 days.

When deals are concluded, the following questions should be asked:
By buyer AND seller when unsuccessful:

- What did we do well during the process?
- What could we have done better or differently?
- How could we have identified concerns/issues earlier and streamlined the process?
- Was missing the transaction a win or loss for the company?

By buyer when successful:

- What did we do well during the process?
- What issues did we miss and why?
- How can we improve our process to identify issues earlier?
- How does what we acquired compare to what we thought we were acquiring?

]Some Additional Points For A Seller To Consider

- Be prepared early on — conduct a due diligence review of your company and clean up any potential issues a buyer may have with your business. Seek professional help, especially if your leadership team does not have buy-side experience.
- Identify a target list of buyers and monitor their deal activity to learn more about their strategic priorities. This will allow you to determine where you "fit" – if at all
- Know your prospective partners — conduct due diligence on each of your potential buyers beforehand, including their ability and reputation for successfully concluding transactions. Determine how you can best position your company or products with each. Learn about your prospective buyers — and their portfolio's and portfolio gaps — from their websites and SEC filings (if publicly traded) and don't be afraid to ask them the same tough questions they're preparing to ask you.
- Be patient — the transaction processes utilized by strategic and financial buyers is disciplined, deliberate and formal. Be prepared to be patient — it could take 5 to 6 months to successfully conclude a transaction in a best case scenario, 6-12 months in a base case scenario and 12 to 18 months in a worst case scenario.
- Focus on running the business — discussions regarding a transaction can be a time consuming distraction for the seller's entire leadership team. Missing sales projections during the process can negatively impact valuation and/or slow the process down.
- Hard factors (desirable financial metrics) will eventually drive a buyer's decision-making — strategic and financial buyers will be focused on identifying, managing and protecting value drivers and eliminating or mitigating risk. Soft factors matter little.
- Don't think you can manage the process yourself — 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.

Some 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 in the

process. 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.
- Maintain integrity — when facing the dilemma of expediency versus doing the right thing, take the long view — and do the right thing.
- Have 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 — and deal closing.

Summary

As M&A activity heats up, CEO's looking to sell their companies within the next 18 months should be mindful of how larger strategic or financial buyers manage deals, including each of the various steps and timeframes in a typical transaction life-cycle process — and start planning now.

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 his business when and to whom he so desires — with greater confidence and less frustration.

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