

Management Briefs

M&A Focus: Deal Structure

BY PAUL DIPPELL

In my first Management Brief article, "Navigating the Mergers and Acquisitions Process," we saw the entire M&A cycle from a high level: value creation, communication, and realization.¹ In this article, we'll fast-forward to its very conclusion: deal structure.

We'll leave for a future Management Brief discussion the *amount* of consideration to be paid, or valuation of the company, and focus here on *how* that consideration will be paid. Forms of payment are generally cash and stock in the acquiring (or newly created) company. What's at play are the timing of the payments and the degree to which the total consideration is based on future, not past, performance. The final deal will be one that meets the risk requirements of both parties. Note that you should retain a professional tax advisor who is familiar with mergers and acquisitions.

In the most straightforward deal,* the buyer pays cash for the assets of the seller's company, based on its recent performance, and pays it all up front. The seller is then free to go. This structure transfers all risk to the buyer and so it is understandably rare, especially in the IT services industry, where owners are usually viewed as having crucial relationships with customers, employees, and partners. Buyers faced with this risk profile rarely are able to pay a price acceptable to the seller. Consequently, sellers, who better understand the risks and opportunities involved in their

businesses, rarely find the value of an all-cash deal to be attractive.

The buyer will want some comfort that relationships and knowledge will be successfully transferred through the continued participation of the seller for some period. Often this comfort is achieved by the use of a deferred payment to the seller, contingent on meeting certain future financial performance goals. This linkage of the final, total selling price to future financial performance, known as the "earn-out," is an effective tool for allocating risk and achieving appropriate valuations for buyers and sellers.

Let's look at the major components of a typical deal and then at how they can be adjusted to meet both parties' needs:

- **Forms of payment:** Cash and stock in acquiring company.
- **Timing of the payments:** Usually split between up front ("on close") and at a point or points in the future ("deferred payment").
- **Variability of total payment ("the earn-out"):** Generally, this takes the form of a later adjustment to the total purchase price, through a deferred payment.

Let's look at types of payment from the buyer's and seller's points of view. The buyer will prefer the type of payment that is cheapest. For buyers who feel their stock is cheap or who have cash, cash may be preferred. When the stock is high and perceived by the seller to be going higher, or cash is dear, then stock may be the buyer's preference. The seller may prefer cash to offset risk or for other reasons, or he may perceive the buyer's stock to be valuable. Of course, in today's market, cash is king!

What will be the timing of these

payments? Commonly, the cash is the up-front portion and the equity is the deferred portion, but this is not always the case. The buyer may want to defer part of the cash portion to preserve cash flow. If the seller's proportion of voting shares in the buyer's company is high, the seller may want shares up front to secure voting rights or, alternatively, to ensure that shares held back can be voted.

Tailoring an earn-out is a notoriously delicate task because so many variables come into play. The buyer is asking the seller to continue to influence financial performance, but he may want to add to or replace management on the team, or expect the acquired operation to adopt companywide objectives and standards. The seller, who feels comfortable committing to future performance based on tried-and-true operating techniques, may feel less sure with these changes. Likewise, neither party can predict external economic forces with precision.

So earn-out language is often fraught with complexity and conditions to anticipate the foreseen and unforeseen. Rules of thumb: Keep it simple, and keep the earn-out period short (a year or even less). A side benefit of a short earn-out is that it encourages a crisp operational transition, which, if well executed, is generally better for all stakeholders.

For these reasons, earn-outs have been decreasing in duration and complexity. Experience has shown that the greatest risk to any acquisition is poor integration after the fact. Both parties want the seller focused on integrating the new assets into the buyer's operation, not on preserving independent control.

How, then, can the buyer ensure that the seller will keep putting his shoulder to the wheel? Assuming the seller remains in management, the buyer can tie part of the seller's compensation (as an employee, not as payment for assets) to the unit's ongoing financial performance. Indeed, the seller can be on the same incentive plan as other management, putting all the new colleagues on the same side of the table.

Also, if some or all of the deferred payment is in equity, the seller has a large incentive to drive future financial performance. In fact, the seller may be uncomfortable with the risks of a de-

ferred payment consisting entirely of equity, especially if the equity is illiquid. If so, the buyer can provide the deferred payment as a convertible note, due a year or so from closing. The buyer's cash flow is protected and so is the seller's investment decision.

Deals gain momentum, which paradoxically may obscure thinking about the post-acquisition operation. By focusing on deal structure, buyer and seller will more likely create lasting value for each other. ♦

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quisitions advice for small and mid-size companies. He may be e-mailed at pdippell@usbx.com.

* For space reasons, we'll focus on asset purchases, in which the buyer acquires the assets, not the stock, of the seller's company. Most buyers will prefer this for tax and auditing reasons, and this generally overcomes any preference the seller may have for a stock swap. ♦

References

1. Dippell, Paul. 2001. Navigating the mergers and acquisitions process. *Sbusiness* 26 (5): 26.

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