Eight Rules of Sell-Side Technology M&A

You're considering selling your company, but are unsure about the process strategy or which banking team to select. For technology companies that will likely exit in a sale, we suggest considering the rules below regarding sell-side M&A processes and the role of investment bankers.

By: Michael O'Hare, Head of M&A, and Chris Hieb, Managing Director, M&A
Pacific Crest Securities LLC

VC's and entrepreneurs invest millions of dollars in building technology companies with the intent of generating financial returns through a sale or IPO. When the Board of Directors determines that it's time to pursue a sale strategy, several decisions need to be made that will impact the company's ongoing business and ultimate exit valuation and structure. In most cases, an investment banker can provide valuable advice and support, resulting in a successful outcome for investors and management.

Below are eight rules that will help you understand the sell-side M&A process and the investment banker's role. These points will also enable you to manage the process more efficiently and effectively. Selling a company is after all, one of the most important events in a company's lifecycle.

Rule 1: It's best to be "bought, not sold"

While this concept does not apply in all cases, it provides insight into the dynamics of leverage in a negotiation. Selling a company is a long and sometimes arduous process, so why not start off with a leg up on the buyer? This cliché represents the fact that if a buyer approaches you with interest in acquiring your company, then you have the upper hand in dictating the process and the negotiation. If you don't have to sell, then you have a viable alternative that allows you to directly compare the risks and benefits of either outcome. On the other hand, if you hire a banker to "shop" the company, then you are trying to convince others to buy you and are inherently passing the leverage to the buyers. It's easier to negotiate under the context, of "hey, you approached me and see great value, so you should move quickly and pay a fair price", as opposed to "take a look at my company, what do you think?" It's also easier to build momentum (see Rule #6) in a process by telling other potential buyers that you have been approached and there is a high probability that the company will be acquired by a competitor.

Most (but not all) technology company sales that result in a high valuation represent a buyer who is convinced that it needs a particular solution. It's not common for the seller to proactively convince a buyer that it needs to buy the company at a high price without having previously worked together in a partnership relationship (*e.g.*, OEM, reseller, etc). Most strategic buyers have sophisticated corporate development groups that proactively identify and partner with potential acquisition candidates.

The "bought, not sold" concept applies mostly to fairly well known companies in active markets where the buyers are aware of most of the players. This concept is less relevant to very small companies or IP asset sales where a broker may be required to "sell" the asset. If your company has not been approached with serious interest or an offer, expect a sales process to take longer and continue to manage the company as if the transaction will not get done.

Rule 2: Valuation means more than just purchase price

Would you accept a valuation that was entirely contingent on future performance? Would you sell your company for a very high valuation, but allow the buyer to come back and recover money up to the purchase price for any minor breach of a representation or warranty? Would you enter into an LOI that only outlined purchase price and was silent on indemnification and closing conditions?

A merger or stock purchase agreement is approximately 75 pages and approximately two pages discusses purchase price. There are many other issues a Board should consider before entering into an LOI or definitive agreement. Attorneys that specialize in M&A and bankers that appreciate the legal terms of a transaction are paramount to a successfully transaction. For example, the carve-outs to the indemnification caps and terms are highly negotiated provisions that are directly related to the risk profile of the investors and management team. Great care needs to be taken negotiating these terms as early as possible when the seller has the highest negotiating leverage. In addition, the exact words of the agreement matter under Delaware law, so attention to detail is important.

Rule 3: Bird in hand is better than two in the bush

It's an old adage, but a good one that applies to M&A. Investors are often biased and believe they deserve a premium valuation. Many valuation methodologies and publicly available statistics may dictate on paper a "market" or "above market" valuation, but valuation is ultimately determined by the type (e.g., big, small, acquisition experience, etc.) and number of buyers. Theoretically, if a company can't go public, then the value from a liquidity perspective is zero until a buyer is willing to close a transaction. If a seller has only one buyer after a thorough market check, then the valuation multiples of other transactions are irrelevant at that point in time. If the valuation is still not acceptable after several rounds of negotiations, then the only way to signal to the buyer that they have to increase the offer or change other terms is to politely walk away. This approach can have serious consequences, because even if the buyer cannot find another quality company with the same solution, they may allocate their resources to another opportunity in a different market (see Rule #4).

Just like in stock investing, it's better to sell too early at a profit than too late with no profit at all. Take every offer seriously, especially when a buyer approaches you because it may be the only offer you receive in the foreseeable future. If you have multiple offers all within the same range, then the market "has spoken" and you have your best valuation. Believing you can get a better deal later is a dangerous game and should only be played when the seller is willing to continue operating the business for the long term.

Rule 4: Walking away is your "silver bullet" – use it wisely

The seller can get frustrated with buyers when negotiating business and legal terms of LOIs and definitive agreements. Most negotiations are professional; however, at times individuals can get emotional or tense and not see the "forest from the trees." Each party may want to do a deal, but there will always be points of contention due to certain assumptions or beliefs about risk allocation or interpretations of previously agreed language.

If the seller determines that a certain term is unacceptable after exhausting all alternatives and opportunities to explain its position to the buyer, then the ultimate strategy might be to walk away. This strategy should be saved for fundamental issues that are unacceptable. All business and legal decision makers should maintain a balance view of the issues and weight all the risks before drawing a line in the sand. If the seller uses this option and goes back to he buyer later, then the seller loses significant leverage and should expect to find it difficult to win other points going forward. More importantly, walking from a deal comes with the risk of losing the buyer all together (see Rule #3). This can be an expensive alternative with respect to legal fees and the costs of management possibly getting distracted during the sale process. On the other hand, walking away can reap huge rewards by scaring the buyer into a higher value or better terms if they believe they will lose the deal to another party.

Each step of a negotiation is a give and take between two parties. The terms should come closer together as time progresses, and a successful negotiation should have a sense of momentum and urgency. Generally speaking it's better to negotiate the key points (e.g., valuation, indemnification, etc.) sooner and/or when the seller has the most leverage, or use other negotiation tactics (e.g., education, patience, delays, etc.) for difficult issues. As the negotiation proceeds, each party will need to make concessions that lead to a mutual agreement. The walk away should be saved for serious issues that are worthy of the associated risks.

An experienced investment banker can help you qualify and quantify the risks when negotiating with one or more buyers. They should have experience negotiating with technology buyers under various circumstances, resulting in the ability to know when to push back and when to accept the offer. The banker's job is not to only maximize value, but to maximize value and manage risk without losing the opportunity.

Rule 5: Bankers don't convince buyers to do deals

The first step in an M&A process is for the banker to call the potential buyers and explain their client has been approached or is considering a sale (see Rule #1). If the buyer is interested, they will ask for additional information and adhere to the steps in the sale process. Bankers are experienced at delivering articulate messages and highlighting key points about the target that a buyer should consider; however, the ultimate decision will be made by the buyer's sophisticated corporate development, product development, strategy and sales managers. There are many reasons why a buyer might decline from participating in a process: buyer already has a similar product or solution; buyer plans to develop the product internally; buyer is focused on other priorities; buyer is integrating recently completed acquisitions; and seller's solution is not part of buyer's long term product strategy, among others. A banker does not control any of these factors. It is also very important to understand that the seller may not agree with the buyer's reason to pass. This does not mean the banker did not articulate the opportunity correctly. Seller's have their own biases and may view their business and future opportunities from many different perspectives (i.e., it may seem like a perfect fit to someone on the outside when in fact the buyer has a variety of closely held reasons for doing something else).

Bankers are catalysts to a process - they manage the process, gather information, articulate risks/rewards, anticipate the buyer's next steps and explain the implications of major decisions. Your Board should not expect the investment banker to be responsible for convincing a large public company to do a deal. Bankers make introductions and assist in positioning the opportunity. The process is a team effort and many factors drive the buyers' decision making processes, some of which will never be disclosed to the banker or seller.

Rule 6: Time kills deals

Building trust and momentum in a process is paramount; but be flexible and evaluate all risks carefully. Time is an especially dangerous element that should be respected. Every seller enters a process hoping that multiple buyers will be excited about their solution, resulting in a short auction process that bids up the price and terms to "above market" levels. A successful process can still be executed even if there is only one buyer. But the longer the process takes, the lower the probability the transaction will close. Each side can become tired or frustrated if parties are too inflexible or constantly renegotiating terms. At some point, each side must take risk and trust the process and the other side. Waiting for other buyers to catch up or walking away (see Rule #4) from a deal can delay the process and increase the probability of external events impacting your process (e.g., the only buyer gets acquired and the seller is left with not exit).

Momentum is easily created when there are multiple parties interested in the seller. However, strong momentum can also be maintained by running an efficient and well organized process that signals to the one buyer that other parties are involved. Maintaining the delicate balance between momentum and credibility is an important role of the investment banker. If there is ultimately only one buyer, the goal is to be responsive, confident and open so that the buyer gets "pregnant" and feels confident completing the transaction. The more time and money the buyer spends, the harder it is for them to walk away assuming no serious diligence issues are uncovered. On the other hand, the more the seller delays, the higher the risk the buyer will not close. Through the process, the seller should be prepared for change and not expect every detail of the planning stage to be realized. The type and number of buyers dictate how the process will evolve. An experienced banker will guide the Board on changes that optimize the outcome of the process and mitigate the associated risks.

Bankers use many strategic and tactical tools to build and maintain momentum. For example: evaluate all historical partnerships and buyer discussions carefully; prepare the data room early; deliver all buyer requests before they are due (buyer then knows the seller means business, is well organized and there could be other buyers); limit the number of managers that know about the process; engage an experienced M&A attorney; and never allow the buyer to attempt to backchannel to management or the Board (the shorter the conversation the better – "please talk to my banker"). PCS would be happy to share other strategies with regard to running an efficient process.

Rule 7: There is no such thing as perfect information

A banker is similar to a CEO in that he/she must make decisions without perfect information. The sell-side M&A process is tailored to discover as much information from the buyers as possible so that the seller can evaluate the associated risks and rewards of proceeding with a transaction. The deal team will never have perfect information regarding the buyer's internal assumptions and approval process. It's the banker's job to get a "feel" for the buyers' motivations and quantify how serious they are in the process. The more thorough the process and the more the banker appreciates the subtleties of communication and negotiations, the more detailed intelligence the Board will have for decision making. However, be prepared to make decisions based on imperfect information. An experienced banker will be able to interpret the feedback and summarize the "market" sentiment about your company and process.

Rule 8: To sell is great, to run an auction is divine (and rare)

The primary assets of a technology company are its people. Unlike many consumer or industrial companies that have a variety of assets that likely generate cash flow, technology companies often rely on their IP and customers as the catalyst for a sale. Certainly many larger technology companies have recurring revenue streams that may have more customer value than IP value; however, it is generally more difficult to run a technology company auction because of the sensitivity to losing key employees or customers.

Approximately 55% of all technology sales are below $100 million and represent “technology” or “customer” buys that will be leveraged through a larger or different sales channel. Most of the targets only have a handful of strategic buyers and financial buyers will not likely be interested if the company does not generate significant cash flow. In addition, the number of strategic buyers has declined substantially, limiting the number of exits for the thousands of potential technology sellers (also see Rule #5).

A sale process for a technology company typically results in one to three highly interested buyers. A full auction with more than three active bidders is possible, but not common. It is very difficult to run an open auction that focuses only on maximizing value when customer and employees need to be managed carefully and buyers have many other priorities. An experienced technology banker should conservatively advise your Board to be prepared for a negotiation with only one buyer. Per all the rules above, an experienced banker can add tremendous value to the process when there is only one buyer.

Michael O’Hare and Chris Hieb lead the M&A Group at Pacific Crest Securities (www.pacific-crest.com). Michael is located in New York City and Chris resides in San Francisco. For more information go to:

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