ACQUISITION SUCCESS FOR BUYERS:

BEING A SUCCESSFUL BUYER IN ANY ECONOMIC CLIMATE

by

Scott J. Lochner

Partner, Foundation Law Group LLP

M&A purchase transactions can be successful in any economic climate for a buyer with a *clear investment thesis*[1] that systematically and strategically: (i) prepares early and plans well; (ii) selects acquisition targets wisely; and (ii) executes his or her planned acquisition process with discipline and competence.

This article seeks to explain the "*how and why*" of the foregoing *to help you*, a prospective buyer, *pursue your acquisition(s)* in any economic climate *in a manner so you can maximize your acquisition target's value, save money, and succeed.*

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In good economic times credit is generally abundant, numerous acquisition targets are typically available for purchase, and upbeat attitudes in general help deals move forward.[2] The opposite tends to be true during economic downturns,[3]

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[1] A "*clear investment thesis*" for a strategic buyer is having a clear idea of how a potential investment could strengthen its competitive position by strengthening the competitive position/foundation it already has, so it can do what it already does better. "In one survey of acquirers, *** about 80% of successful transactions were based on a clear investment thesis. For failed deals, the proportion was about 40%. *See* S. Rajan and D. Harding, "*Recessions can present rare M&A opportunities*", Bain & Company, at 3 (April 16, 2009) (hereafter "Bain").

[2] "Common wisdom holds that acquisitions should be pursued when the economy is strong and companies are flush with cash, a strategy termed "buy rich." *See* "*Deal-making in downturns: The 'big black cloud of slowdown has a silver lining*", Deloitte Development, LLC, at 1 (2017) (hereafter "Deloitte").

[3] "M&A activity crashes during a recession. This is because, for an M&A transaction to occur, someone has to sell. During a recession, the price owners can obtain for their equity in the business falls. Their desire is not to "sell low," of course, so they wait on the sidelines until the price they can obtain is more attractive." *See* "*Does Merger and Acquisition (M&A) Activity Rise Or Fall During A Recession? Why?*", M&A Blog, Acquisition Advisors (October 26,

although, for the well-prepared buyer that is relatively strong strategically and financially, recessions provide rare opportunities to obtain bargains and fire-sale prices that can produce outsized returns.[4]

Whether the economy is booming or slumping, a successful buyer is *always* focused on using an acquisition to strengthen his or her existing competitive position/foundation. Such focus requires having a *clear investment thesis*.

I. A "*Clear Investment Thesis*".

Having a "*clear investment thesis*" means you clearly understand how a potential acquisition could strengthen your current competitive position/foundation, and how -- assuming the acquisition is successfully completed -- the acquisition would enable your business to do what it already does, only better.

Allowing your business to do what it already does, only better, raises the fundamental question of what does your business do.

The answer to this question will be largely based on how you view (or should view) your business, which is key, and is not nearly as simple as it may initially seem. The

2014). Also, "buyers lose confidence in the future. They're not sure when things will turn around and don't want to buy and then own a business during a prolonged recession." *Id*. Further, "[w]ith less equity available fewer deals get done. Last, debt financing becomes scarce." *Id*. *See also* Bain, at 1-2 (April 16, 2009).

[4] A study by Bain & Company of about 24,000 transactions revealed that acquisitions completed during and just following a recession generated nearly three (3) times the excess of returns of acquisitions made during the preceding boom years. *See* Bain, at 1- 2. *See also* Deloitte, at 2. See also D. Rigby, *Winning in Turbulence: Pursue Game-Changing M&A and Partnerships*, Harvard Business Review, at 1 (March 6, 2009).

"[W]ithin the big black cloud of an economic slowdown there is a silver lining; an opportunity that many organizations fail to acknowledge let alone seize. During market downturns, strategically focused companies can challenge the status quo and disrupt stagnant thinking by using mergers and acquisitions (M&A) to create new avenues for significant growth, shareholder value, and competitive advantage." *See* Deloitte, at 1. "A slowdown in economic activity may present a much more significant challenge for smaller or underperforming companies versus their larger and better capitalized competitors, resulting in opportunities for consolidation, distressed sales, and buyouts." *Id*. Indeed, "[d]uring the financial crisis of 2007-2009, [private equity] firms initially slowed their M&A activity, only to crank it up again as they recognized the value presented by lower valuations. *Id*.

answer requires a lot of hard thinking. To illustrate and better explain, let's look at the history of two well-known U.S. companies: *Apple* and *Kodak*.

Apple. In the first decade of this century, *Apple Computer* (Apple's original name) broadened its self-image as an innovator and maker of "*computer boxes*" to a broader self-image of being an innovator and maker of "*personal technology*".

Through internal development and acquisitions, Apple proceeded to broaden its competitive position/foundation by developing new *personal technology* products, such as the *iPod*, *iPhone*, and *Apple TV*, which allowed Apple to *do what it already did, only better*, and greatly enhanced its growth and profits. These new Apple products were not stumbled upon, but were based upon Apple's existing competitive position/foundation as a computer innovator and maker plus its heightened awareness of what its real business was, that of being an innovator and maker of *personal technology*.

Consequently, *Apple Computer* changed its former self-limiting name to simply *Apple*.[5] The rest, as they say, is history.

Kodak. On the flip side of Apple is Kodak, a once great company whose unchanging view of itself doomed it. For decades Kodak held the dominant position in photographic film. Although Kodak invented digital photography, and clearly had the resources to become a market leader in the field -- through either internal development, acquisition(s) or both -- Kodak always remained narrowly focused on its analog film business until it was too late. Had Kodak been more alert, less short-sighted, and been able to see itself more broadly -- as an "*image products company*" instead of only as a "*film company*" -- it could have broadened its competitive position/foundation and protected its future. Had it done so, and in doing so increased its competitive advantage, its business might not have suffered and been greatly marginalized as digital photography became mainstream. Indeed,

[5] *See* M. Hogan, "*Apple drops 'Computer' from name*", PC World (January 9, 2007). "Don't call it a computer company." "'The Mac, iPod, Apple TV and iPhone. Only one of those is a computer. So we're changing the name,' said [Steve] Jobs." "Formerly Apple Computer, the name change reflects the company's newfound emphasis on consumer electronics." *Id*.

Kodak might even be more prominent and prosperous today than it was at its former peak, instead of going bankrupt.[6]

AGAIN, a *clear investment thesis* is a clear idea of how an investment can strengthen your competitive position by strengthening the competitive position/foundation you already have, so you can do what you already do better.

To determine *what your business is*, so you can develop a *clear investment thesis*, you need to ask yourself questions such as: *Why is my business making money? What is my competitive advantage? What are my current results, and what could make them stop? Who are my customers/clients? Are any changes in technology disrupting my competitive position/foundation, either today or potentially tomorrow? What trends are occurring in the marketplace that are affecting or could affect my customers (or my desired customers), even if only indirectly? How do I envision my business will (or should) look in 5 years? In 10 years? In 20 years?*

You need to develop a clearly articulated and informed future vision. What kinds of customers, products, competition, and markets do you anticipate based on what you know now? <u>Once you create a clear vision of what you want for your business</u>

[6] During most of the last century, Kodak - the company that created mass-market amateur photography - held the dominant position in photographic film. "By the end of the [1960s], Kodak had the entire photography industry sewn up; it had sales exceeding $4 billion (somewhat around $50 billion in today's money) [and] 100,000 employees...." *<u>See generally</u>* S. Anthony, "*The history of Kodak: Pioneer of film and digital photography*", <u>ExtremeTech</u> (October 12, 2011).

"[K]odak was a pioneer in digital imaging. In 1975 the first ever charge-coupled device (CCD) image sensor was made by Steven Sasson, an engineer at Eastman Kodak...." "[I]n 1986, Kodak developed the first camera-sized megapixel sensor; and in 1991, Kodak created the first digital SLR camera...." "...Kodak simply did not move fast enough to stave off Japanese competition." "Kodak's focus was always on its massively profitable analog film business." *<u>Id</u>*.

Consumers gradually switched from analog photography using film, to digital photography without film. In January 2012, Kodak filed for Chapter 11 bankruptcy protection. *<u>See</u>* "*Eastman Kodak Files for Bankruptcy*", <u>N.Y. Times</u> (January 19, 2012).

in the future, you can work backwards to organize your plans and strategies to build your optimal desired future.[7]

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II. Preparing Early and Planning Well, Selecting Your Acquisition Targets Wisely, and Executing Your Planned Acquisition Process with Discipline and Competence.

a. Preparing Early and Planning Well. To be a successful buyer you need to prepare early and plan well. Smart and experienced buyers will often invest months or even years in deciding upon a *clear investment thesis* and in planning *how best* and in deciding *when best* to proceed in making an acquisition.[8]

(i) Planning How Best to Succeed – Creating Your Acquisition Plan

Your acquisition planning begins with your selection of your acquisition management team (the "Team"). Team members should bring different skill sets to the acquisition effort, and Team responsibilities should be allocated among various Team members based upon their respective skill sets.[9] You should chair the Team,[10] and you may want to include your business mentor (if you have one) as part of your Team to assist you in organizing and coordinating its efforts.

The next step is for you to have your Team develop *outcome-focused* "acquisition target attributes" and "acquisition target quantitative metrics" based upon the

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[7] In considering the future, do not only consider a narrow trend and forget the rest. There is a fusion of numerous forces that create the future – not one trend alone, but a convergence of trends. You need to "fold time" backwards to envision new products and services.

[8] *See* Bain, at 2.

[9] Your internal working team should be "made of representatives from finance, sales and marketing, and operations. You may also want to consider using outside experienced advisors such as lawyers, accountants, investment bankers, valuation experts, and in some cases insurance or employee benefits experts." *See* C. Brown, "*5 Tips for Executing a Successful Acquisition*", Inc. (December 22, 2010) (hereafter, "5 Tips").

[10] "[T]he quarterback of the acquisition team should be the CEO or someone appointed by the CEO, who must clearly define [the] responsibilities and authority of each team member." *See* 5 Tips.

acquisition outcome desired. These attributes and metrics should serve as key gating parameters that will define both your target selection as well as the success of your acquisition effort.

Broad and important questions that should be asked and answered include, without limitation:

1. What are the success criteria for the acquisition effort?

2. What business gap(s) or shortfall(s) is the acquisition attempting to address?

3. What are the desired target *attributes* and desired target *quantitative metrics*, and are they consistent with the *clear investment thesis*?

4. Should any *qualitative metrics* be considered, and if so what are they?[11]

5. How will target companies to buy be located and chosen?[12]

6. How much can we afford? What purchase price range in general is acceptable?

7. What is the acquisition timetable?

Some of the target *quantitative metrics* should include desired minimum financial metrics, such as target balance sheet quantities and earnings. In addition, your Team-approved written acquisition plan (the "Acquisition Plan") should include, without limitation: (i) your ideal acquisition transaction structure (and related tax consequences); and (ii) how much of a purchase price your company is prepared (and able) to pay for your proposed acquisition. Related to your purchase price range and price limitation is what "form" your acquisition consideration should take (e.g., cash, stock, loan, etc.),[13] and an initial list of which entities to approach

[11] See note 19, below.

[12] The team should decide if an investment banker should be retained to find targets, or if acquisition targets will be generated internally through screening, networking, and industry contacts, or if some other search means will be used. *See* 5 Tips.

[13] *See* notes 21, 22, and 23, below.

for third-party financing assistance (if any). Also to be considered is whether earn-out provisions[14] or rollover provisions,[15] on a case-by-case basis, should be included in your target purchase bid(s) "to make a competitive offer that aligns the parties while protecting you from overpaying".[16]

Some of the *target attributes* you may wish to consider include *qualitative values* such as if your target should have an "*economic moat*" around its business,[17] whether your target should have a tight "*cultural fit*" with your company,[18] and whether other "soft factors" such as entrepreneurship, integrity, and reputation are important value components in your acquisition selection.[19]

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[14] An "earnout" is a payment for performance after the sale transaction has closed. "It is a contractual arrangement in which if the business, after its sale, reaches or exceeds a certain agreed-upon financial target or other milestone during a specified period, buyer will pay seller additional consideration pursuant to the agreed upon formula." *See* S. Lochner, "*EARN-OUTS: A Useful Tool in M&A Transactions for Bridging Gaps in Perceptions of Business Value*", VC Expert's Encyclopedia of Private Equity and Venture Capital, January 2009 (https://www.vcexperts.com/buzz_articles/636).

[15] A "rollover investment" is a non-control, post-closing equity participation by seller's owner(s)/management team of acquiring typically 10-40% of the equity of the purchasing buyer (which may, for example, be the subsidiary of another much larger entity). M&A participants use a rollover investment in M&A transactions to (i) bridge finance and valuation gaps, (ii) incentivize on-going management, (iii) provide seller's management with participation in potential future appreciation (e.g., a subsequent private equity exit, an initial public offering, or a sale), and (iv) aligns seller's management with buyer.

[16] *See* note 28, below.

[17] An "economic moat" is the durability of a company's competitive advantage (i.e., its ability to maintain a competitive advantage over its competitors to protect its profits and market share), and Warren Buffett believes it the most critical factor in picking a successful investment. *See* T. Smith, "*3 ETPs to Play Buffett's Moat Advantage*", Investopedia (August 8, 2018) (hereafter "Smith").

[18] A discussion of the meaning, potential importance, and purported methods of measurement of "cultural fit" is beyond the scope of this article.

[19] A review of *qualitative* "soft factors" such as entrepreneurship, integrity and reputation is a practice recommended and used by Charles T. ("Charlie") Munger of Berkshire Hathaway. *See* L. Cunningham, Berkshire Beyond Buffett: The Enduring Value of Values, Columbia Business School Publishing, Columbia University Press (2014), at 13 (hereafter "Cunningham"). As Charlie Munger advised Warren Buffett early on in their relationship: "[I]t's better to buy a good business at a fair price, than a fair business at a good price." *Id*.

It is important to have your Acquisition Plan be complete, achievable, and address all of your acquisition requirements, including your *clear investment thesis*. Your Acquisition Plan should be reviewed periodically and updated as necessary and appropriate.

(ii) Acquisition Financing: How Much of a Purchase Price You Are Prepared (and Able) to Pay, From Where Will the Payment Come, and What Type of Acquisition Financing Will Be Used

You need to decide in your Acquisition Plan *how much* of a purchase price your company is prepared (and able) to pay for your tentative acquisition. This question is generally answered by the current financial condition of your company, how much third-party "*acquisition financing*"[20] you can secure (assuming you do not intend to solely self-fund), and how much within those constraints you are prepared to spend.

Also, you need to think about and decide upon what *type or types* of acquisition financing you intend to offer your target, with the most common types being cash,[21] stock,[22] term loan,[23] and SBA 7(A) loan.[24] Please note that there is an entire "business funding solutions industry" that wants to help you (and themselves) with

[20] "Acquisition financing" is a type of business funding obtained for the purpose of financing the acquisition of another business.

[21] Cash is frequently used to pay for an acquired company, and the use of cash usually removes equity holders from the acquired company, placing the target company under the buyer's control.

[22] Stock of the acquisition company is a common form of acquisition finance. The acquiring company issues stock to stockholders of the target company in exchange for the acquisition of the target company.

[23] Term loans are often used for acquisition financing, and typically offer a fixed interest rate along with a predictable monthly repayment schedule. There are "various flavors" of term loans, so you should always be sure to review the fine print.

[24] SBA 7(A) loans are offered through the U.S. Small Business Administration (SBA). They are a special type of loan that is guaranteed, offering an incentive to lenders to approve loans for small businesses.

a myriad of financing solutions to assist you in financing your tentative acquisition.[25]

Last, as earlier noted, “it can often be useful to include earn-out provisions[26] and rollover provisions[27] in [your] purchase bid to make a competitive offer that aligns the parties while protecting [you] from potentially overpaying.”[28]

Please note that for you to succeed with your acquisition target offer bid, you may be required -- on a case-by-case basis – to modify the type or types of your purchase price consideration.

b. Selecting Acquisition Targets Wisely. Once your Acquisition Plan is complete, your next step is identifying appropriate tentative real-world target opportunities.[29]

In making your real-world target selection(s) you must be able to “demonstrate the logic of how the deal will create additional value. *** Will the purchase help [you] grow [your] core business; make it easier to attract new customer segments; extend [your] value chain; bring in a new, game-changing technology; or help [you] enter adjacent markets?”[30] Whatever your rationale for your proposed acquisition

[25] Discussion of the “business funding solutions industry”, the scores of alterative means of acquisition financing, how acquisition financing solutions compare, and how to obtain an optimal deal when contracting to obtain an acquisition financing solution is beyond the scope of this article.

[26] *See* note 14, above.

[27] *See* note 15, above.

[28] *See* S. Lochner, “*Sell-Side and Buy-Side Transaction Tips for Today’s M&A Deals”*, Inside the Minds, Aspatore (2011), at 87 (hereafter “Lochner”).

[29] *See* note 12 above. Please note that once you identify your real-world tentative targets, and have had an opportunity to conduct a financial due diligence review of them, internally and/or through your outside accountants, you will most likely want and need to update, amend, and add more detail to your Acquisition Plan as to how much and what type or types of acquisition financing you may wish to propose to offer them.

[30] *See generally* “*The Art of Successful Acquisition*”, The Boston Consulting Group, Inc. (2015), at 10 (hereafter “The Art of Successful Acquisition”). For example, an ideal target might be “a business that fills out a geographic region or a product line or a technical hole.” *See* Conerly.

is, it should clearly explain how your acquisition will strengthen your position in the marketplace and create additional business and greater wealth for you.[31]

You should be aware that "[t]here are no shortcuts to finding targets."[32] Successful acquirers *** search for, pinpoint, and pursue targets which are an excellent fit, starting with a crystal clear understanding of their target's current business."[33]

Whether you search for your real-world targets on your own, or with the assistance of a business broker or an investment banker,[34] issues in your selection process that you should consider include: (i) how strong is the "*strategic fit*" of the target with your business (in terms of business model attractiveness, customer/client perspective, and technical suitability); and (ii) how attractive is the target (in terms of competitive intensity, margin potential, and growth).[35]

Questions you should ask yourself include, without limitation: *What is the strategic potential of target's entire business? What is its potential to create more value in the future? Can you, as the target's new owner, capture and realize the target's inherent value?*[36]

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[31] *See* The Art of the Successful Acquisition, at 10.

[32] *See* The Art of the Successful Acquisition, at 11. How to locate specific real-world company targets for you to potentially purchase is beyond the scope of this article. That said, see note 23, above.

[33] *See* The Art of the Successful Acquisition, at 2.

[34] You should consider the potential merits of retaining an investment banker to locate potential targets once you have decided upon and know the general parameters of the acquisition target(s) that you are looking to find. Generally, use of a competent and experienced investment banker familiar with the industry of your desired target(s) is invaluable. If you decide to retain an investment banker, it is in your interest to have your business mentor or M&A legal counsel review your investment banker's engagement letter for market fairness before you enter into it, since once it is signed it will last for a long time, including the "tail period" which continues even after the investment banker's engagement expires or is terminated.

[35] *See* The Art of the Successful Acquisition, at 11.

[36] *Id*., at 4.

c. Executing Your Acquisition Process with Discipline and Competence.

Now that you have chosen one or more real-world acquisition targets that fit your Acquisition Plan criteria, you are ready to move forward with your tentative acquisition transaction with discipline and competence. If you simply stay the course and follow your Acquisition Plan, as it is amended and revised by you from time to time, you should be in a position, at *your optimal time*,[37] to (i) pounce faster than your rivals, (ii) make a well-thought-through offer to purchase your target, and (iii) take all of the next steps in a typical M&A purchase transaction to successfully acquire your target,[38] and integrate it into your business successfully[39] and fully exploit its rewards.

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III. Three (3) Best Practices of Successful Buyers.

During your overall acquisition process, three (3) best practices of successful buyers that you should *always* keep in mind are the following:

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[37] What is your "optimal time"? Your optimal time to proceed with your acquisition is a function of your readiness, needs, time horizon, strategic and financial strength, and stomach for risk. If you have a specific real-world target in mind, and can afford to be patient and wait, an ideal opportunity may arise in which you can obtain a better price and deal terms. For example, if you have an ideal target that you have identified but can wait, a time may come when the target's owner has some reason to sell other than the price being high. "It could be the retirement of the owner, or a spin-off of a division that doesn't fit the company's long-term strategy." See B. Conerly, "*Now is Not the Time for M&A*", Forbes, at 2 (June 10, 2018).

Overall, the best answer as to when to best proceed is after you have: (i) a clear investment thesis, and (ii) systematically and strategically have prepared early and well, including selecting a competent Team and creating a complete-and-thorough Acquisition Plan, and feel confident that you are prepared and ready to move to the next step.

[38] A description of the various legal steps for a buyer to maximize his or her position in the actual negotiation and documentation of a M&A purchase agreement is beyond the scope of this article.

[39] See generally, S. Lochner, "*How You as a Buyer Can Save Your Acquisition Victory from the Potential Jaws of Defeat: Early Preparation for an Accelerated Transition Immediately Following the Closing of Your M&A Transaction*".

1. **<u>From Time to Time Update Your Target List for the Changing Environment of Today and the Direction of Tomorrow (Based Upon Your *Clear Investment Thesis*)</u>**.

Be aware that once-successful business models may no longer work, or may be about to decline, fail, and be replaced. Target companies that were once market leaders may be headed for a major fall.

The key is for you to have a clear investment thesis that reflects both the new market reality of today and the direction of tomorrow. You should not attempt to use your acquisition deal to totally reshape your existing competitive position/foundation. You should use your acquisition deal instead to strengthen it, and to do what you already do better. <u>Remember</u>: *You should use every acquisition you make to give yourself a better competitive advantage against your rivals*.

Accordingly, you need to evaluate each of your tentative acquisition targets and update your target list for the changing market environment of today, and for where you see your market headed tomorrow. You can emerge stronger from even a very poor economic climate as long as your deal is based on a sound assessment of new market conditions as they affect your business.

It is important for you to keep these facts clearly in mind when you consider and carefully evaluate your real-world potential acquisition targets.[40]

[40] Sometimes a new business method or technology arrives that in just a few years erodes and virtually terminates the existence of an older one. An example of this phenomenon is the relatively fast demise of once popular Blu-Ray, DVD, and video rental brick and mortar stores operated by companies such as Blockbuster®. In a few short years these stores were largely driven from the marketplace, mostly due to competition from the Netflix® mail-order home movie service (i.e., the adoption by consumers of a new business method) and new video-on-demand online streaming media services (i.e., the adoption by consumers of a new technology). Blockbuster® went from its peak in 2004, with over 9,090 store locations, to only 6 years later, in 2010, having only 1,700 store locations when it filed for bankruptcy. As of November 2013, Blockbuster® was defunct. Other examples of new business methods often coupled with new technology swiftly upsetting established patterns of the traditional business order abound. *<u>See</u>* "*Blockbuster, LLC*", <u>Wikipedia</u> (https://en.www.wikipedia.org/wiki/Blockbuster_LLC), 2018.

2. **Getting Your Real-World Target Valuation Correct (For You)**.

Based on your (i) financial due diligence review of your target, and (ii) general financial review of the current marketplace for similar targets (and recent sales of such targets), you should determine a valuation for each of your tentative targets and decide how much of a premium (based in part on its special strategic value to you), if any, you are potentially prepared to offer to acquire each of them.[41] Also, you should decide in advance how much you are prepared to increase your offer if you find yourself in a competitive bidding war, so you do not become overly emotional and end up overpaying and later regretting it. Draw for yourself in advance a "line in the sand" and *be disciplined*. Remember: *Having no deal is better is better than having a bad deal*.

In addition to preparing for a review of your target from a *quantitative* perspective, such as a statistical analysis of balance sheet quantities and earnings, you should plan to undertake a review of *qualitative* "soft factors" such as entrepreneurship, integrity, and reputation, a practice recommended and used by Charles T. ("Charlie") Munger of Berkshire Hathaway.[42] As Charlie Munger advised Warren Buffett early on in their relationship: *"[I]t's better to buy a good business at a fair price, than a fair business at a good price*."[43]

In your valuation analysis you should determine if your target has an "*economic moat*" around its business,[44] and if so how big it is.[45] "A company creates a moat

[41] "No one valuation method will answer the real question which is what is the business actually worth. Value is in the eye of the beholder. Generally speaking, market value is one indicator. Other price factors are capitalization of earnings, discounted cash flow, and net return of assets or equity. But you also want to consider strategic value, meaning what is the projected earnings stream under the proposed new ownership. Look at assets such as customer lists, brands, intellectual property, and licenses." *See* 5 Tips.

[42] *See* L. Cunningham, Berkshire Beyond Buffett: The Enduring Value of Values, Columbia Business School Publishing, Columbia University Press (2014), at 13 (hereafter "Cunningham").

[43] *Id*.

[44] *See* note 16, above.

[45] How to determine the size of a company's economic moat is a detailed discussion beyond the scope of this article.

through cost advantages, having a size advantage, ensuring high switching costs and possessing unique intangibles, such as patents and brand recognition."[46] How durable a company's moat is – i.e., how long it lasts before it disappears -- is a company's "*competitive advantage period*"[47] If a company loses its moat, and "a feedback loop turns negative, it is hard for any company to regain what it once had."[48] For investors who acquire companies with moats, a "moat has special value because [moats] can sometimes survive financially, even if management talent does not deliver as expected or they leave the business."[49]

Please be reminded that, as you know, your valuation determination is very important because if you underbid you may lose your acquisition opportunity, but if you overbid and ultimately overpay, your post-closing rate-of-return on your acquisition will suffer. If you overpay and exceed your budgeted purchase price consideration, the monetary gain you expected from your acquisition may totally evaporate or actually end up being a negative number.[50]

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[46] *See* Smith. A further and more detailed discussion of economic moats is generally beyond the scope of this article.

[47] *See* T. Griffin, Charlie Munger: The Complete Investor, Columbia Business School Publishing, Columbia University Press (2015), at 173.

[48] *Id*., at 175.

[49] *Id*., at 177.

[50] In the late 1980s and early 1990s, when Japanese investors were purchasing Rockefeller Center in New York, the Pebble Beach Golf Course in California, and numerous other American iconic landmarks as well as hundreds of other U.S. companies in numerous industries and businesses, as an M&A lawyer I represented a major then privately-held Japanese company in its acquisition of a comparatively smaller company in Orange County, California. The target company had an investment banker to assist it, while my Japanese client did not, in part because its President (hereafter "Mr. K", whose real name shall remain anonymous) -- who was also a major shareholder of my multi-billion dollar client-- was dead-certain he understood value and was determined to do whatever he thought necessary to win his acquisition target at all costs. It was, it should be noted, Mr. K's first foray into the American marketplace, and on the business-side (the U.S. marketplace not being the Japanese marketplace) he was arguably very unprepared.

Sadly, despite my numerous polite warnings to him (although it was outside of my role as his lawyer, and therefore my advice on non-legal matters was politely disregarded), Mr. K ended up paying over twice as much as his target's current market value based upon the target's EBITDA and then-applicable EBITDA multiple, recent comparable transactions, and other basic quantitative measures of value.

Many acquisition targets, as earlier mentioned, are comparatively inexpensive during downturns. While this may seem like a real opportunity for you to obtain a bargain that in time can produce an outsized return for you (which it may), sometimes targets are cheap for good reasons and, as the saying goes, "you get what you pay for".

Consequently, you should *always* undertake your financial due diligence review methodically, patiently, and thoroughly, and never skimp on it. Get a thorough-and-deep understanding and crystal clear picture of your target's financial condition, the trend of its financial condition, and a clear understanding of the reason for the trend. Only then proceed in accordance with your pre-planned and disciplined approach to acquire your target.[51]

3. **Being Patient, and Performing an Extremely Thorough Due Diligence Review of Your Target**.

Your target will be in a rush and want you to conclude your due diligence review as quickly as possible. As an M&A lawyer with a few decades of legal practice experience and a few hundred M&A deals under my belt, I strongly encourage you

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A little over a year after the acquisition closed, during a private one-on-one meeting Mr. K asked me my view as to why the U.S. company he acquired was only achieving about half the return-on-investment that had been projected based on the target's pre-purchase financials. Sadly, I had to gently remind Mr. K that, as he and I had earlier discussed, based on traditional measures of quantitative value he had overpaid for the target company by at least 100%, and consequently the return-on-investment for his acquisition was only about half of what had been expected.

In the many subsequent acquisitions I handled for Mr. K over the next several years, U.S. investment advisors were retained by him and he always actively sought out my advice and listened more closely.

What happened to Mr. K during his first acquisition in the U.S. marketplace happened to many other Japanese investors acquiring U.S. companies during this period: overconfidence, combined with insufficient preparation and planning.

[51] Please note that a discussion of buyer-side legal aspects of an acquisition, such as obtaining a buyer-friendly non-disclosure agreement, a "no shop" exclusivity agreement, and possibly a buyer-friendly non-binding letter of intent (which might include a seller "no shop" exclusivity provision for a specified period, together with a related due diligence review period), as well as a definitive acquisition agreement and all that it entails, is beyond the scope of this article.

to be patient and perform an extremely thorough due diligence review of your target. Do not, I urge you at your peril, rush or scrimp in your financial or legal due diligence review of your target! You owe it to yourself to get the most accurate and detailed "snapshot" and understanding of the business of your target as is possible. If you eventually buy your target you will later need the information to operate your acquired target.

Being patient and performing an extremely thorough due diligence review of your target is something you will thank yourself for later, as <u>it will pay you significant "dividends" in the form of reducing your risk</u> in:

(i) confirming your target is in financial and legal good order, <u>and</u> concomitant therewith;

(ii) <u>allowing you to uncover problems that you can require your target to address now</u> (i.e., before the acquisition signing and closing), <u>at your target's sole expense</u> (and not yours); and/or you potentially getting (x) your target to agree to accept a reduction in your purchase price offer, and/or (y) more buyer-friendly transaction terms.

If any problems of your target that you uncover are bad enough and cannot adequately be addressed to your satisfaction, you can and should "walk away" from the deal. <u>Again, please remember this mantra</u>: *Having no deal is better than having a bad deal.*

In general, you need to be patient and do everything that is necessary to get a thorough-and-deep understanding and clear picture of your target's (i) financial and legal landscape, (ii) day-to-day operations, and (iii) actual business (i.e., *determine what its business actually is, which as earlier discussed is not always obvious*), so that in addition to everything else you can confirm it meets your *clear investment thesis*.

As noted, the issues you uncover in your careful-and-thorough due diligence review can often be used by you to (i) lower your purchase price and/or get more buyer-

friendly deal terms,[52] and (ii) avoid an attempted and potentially expensive indemnification "claw-back" by you later, after the acquisition deal signs and closes (assuming post-acquisition you discover the problem issue(s) in time).

Please note that <u>you have much more power to correct problems of your target that you uncover before signing and closing the acquisition deal than you do after signing and closing the deal</u>, since before you sign and close you hold all the acquisition money/consideration, and you retain the ability to "walk away" from the deal. These facts are no longer true after the deal has been signed and closed, and any attempt by you at a post-closing indemnification "clawback" is typically a negotiation to avoid formal arbitration or litigation, in which you will often -- to avoid lengthy, expensive, and somewhat risky arbitration or litigation -- end up accepting only a percentage of your true damages (in order to be prudently cost-effective and put the matter to rest).

Some buyers in lower-end acquisitions, in order to save time and transaction expense, elect to essentially forgo a due diligence review of their target altogether. They rely almost solely on the target's representations and warranties in the definitive acquisition agreement. This approach is very risky and is generally not advisable. It assumes that the buyer has asked all the correct representation and warranty "questions" and that the target has correctly "answered" them (which by not performing a due diligence review of target the buyer cannot really confirm). It also assumes that the buyer will discover a pre-closing target representation and warranty breach before the limited representation and warranty *survival period*[53]

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[52] In the first decade of this century I represented a well-known international hotel brand in its acquisition of the then largest Broadway theater in New York. In negotiating the acquisition agreement, a not uncommon struggle arose over the language of the indemnification provision. I wanted greater protections for my client, and the other side wanted to provide less protection. As part of my client's due diligence review of the target, I learned that only one week earlier, while the theater was empty, a large chandelier fell from the ceiling, crushing four of the unoccupied seats. Had the chandelier fallen during a live theater performance with the seats occupied, death and/or severe injury would have occurred. I was able to bring this piece of due diligence information to my negotiations, and promptly obtained the indemnification language I had been seeking (and even a bit more!). This is but one small real-world example of how buyer due diligence can be used to obtain more buyer-friendly acquisition deal terms.

[53] The "survival period" is how long the representations and warranties in the definitive sale agreement last, after which time buyer cannot make a claim for an alleged breach of those representations and warranties in an effort to

expires, so the buyer can attempt to make a "claw-back" indemnification claim. These assumptions are dependent on the maker(s) of the representations and warranties having money post-closing that can be "clawed back",[54] and that it will be cost-effective for the buyer to make and prosecute an indemnification claim and to obtain 100% of the damages the buyer sustained. This rarely happens in the real world.

Also, strategic buyers in the same industry or business are often overconfident that they think they know their industry or business, and accordingly often skimp on performing a thorough-and-complete due diligence review of their target. This is a huge mistake that can be extremely costly. Upon closer examination, many acquisition deals turn out to be less attractive than initially believed. In truth, such a strategic buyer should be performing more, and more intelligent, due diligence on a target given the buyer's special and unique knowledge of his or her industry or business. In other words, a strategic buyer in the same industry or business has less of an excuse for potentially failing to separate the "*wheat from the chafe*" in successfully acquiring a solid *synergistic* target and in integrating it and operating it successfully during the post-closing transition period and thereafter.

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Use by you of these three (3) buyer-side best-practices should always greatly increase your odds in (i) confirming whether or not you made a wise real-world tentative acquisition choice, and (ii) saving you significant time and money -- often immediately, but for certain in-the-long-run. It is far costlier to make a bad

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potentially "claw-back" a portion of the purchase price. It should be noted that a sophisticated buyer will "slice and dice" survival periods, negotiating shorter or longer survival periods for different representations and warranties based on their perceived importance in general and to the instant transaction in particular.

[54] The risk is that target (or its sellers) will not have money for the buyer to potentially "claw-back" post-closing due to a material seller-side breach of a seller representation and warranty in the definitive agreement. For that reason, the buyer should retain a certain percentage of its purchase consideration as either a hold-back (i.e., kept by the buyer) or place such amount with an escrow agent pursuant to an escrow agreement for a period of time ideally concomitant with the survival period for the representations and warranties in the acquisition definitive agreement.

acquisition than to simply "walk away" from one, regardless of where you are at in the acquisition process.

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IV. **Summary and Conclusion**.

You can be successful in making an acquisition in any economic climate. To position yourself to do so, in summary you need to prepare early and:

1. Clearly understand what your business *is*.

2. Develop a "*clear investment thesis*" that strengthens your current competitive position/foundation, that if achieved would allow you to do what you currently do, only better.

3. Select your Team and create your Acquisition Plan. Determine how much of an acquisition purchase price you are prepared (and able) to pay, from where the payment will come, and what type or types of acquisition financing you intend to offer your potential target.

4. Locate and select prospective real-world targets that appear to be a strategic fit and conform to your Acquisition Plan, and be able to articulate for yourself and others the rationale of how an identified target opportunity will create additional value for your business (i.e., your "value creation logic", this being a variation of item 2 above).

5. Perform a complete-and-thorough *financial due diligence review* of your real-world target, and a general financial review of similar targets, and determine your buyer-side valuation for your real-world tentative target, and also decide upon how much of a premium (based in part on its special strategic value to you), if any, you are prepared to offer.

6. Determine approximately (i) how much third-party acquisition financing you expect to need for your offer, (ii) what type or types of acquisition financing (e.g., cash, stock, term loan, and/or SBA 7A loan) you intend to include in your offer, and

(iii) whether you intend to propose an earn-out or rollover investment to make a more competitive offer.

7. Perform a patient and extremely complete-and-thorough *legal due diligence* review of your target.

8. Have the courage to "walk away" from a "bad deal" if the fit seems bad or you have identified significant problems with your real-world target that cannot be addressed to your satisfaction.

9. Be disciplined, be patient, stick to your plans, and do not overpay.

Your goal is to get your offer accepted by your target without overpaying.

In sum, if you can systematically and strategically prepare early and plan well, select acquisition targets wisely, and execute your planned acquisition process with discipline and competence, you will be far ahead of most other buyers, and more important you will be in an excellent position to be a successful M&A purchaser in any economic climate.

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The views in this article express the personal views of the author and do not represent the views of any other person or entity and do not constitute legal advice. This article only generally touches on some of the many complexities in reducing risk and in being a successful buyer in any economic climate in a merger and acquisition purchase transaction.

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Scott J. Lochner was raised in Pennsylvania and received his J.D. degree from the New York University School of Law, where he was an Articles Editor on the Journal of International Law and Politics. Scott received his B.A. degree with high honors, Phi Beta Kappa, from Lehigh University, and spent his junior year abroad at the London School of Economics. He is admitted to practice law in California, New York, Massachusetts,* and the District of Columbia.* Scott's background includes

over 20 years of practicing both business law and transactional IP law in Los Angeles as a Partner and Special Counsel at two large prominent national law firms, each headquartered in Los Angeles. In addition, he also at times has served clients as temporary in-house general counsel for several public and private companies. In his law firms Scott advised clients ranging from family-owned businesses to multi-national corporations headquartered in the United States, Asia, and Europe in a broad variety of industries. In addition to general business counseling, Scott has specialized in: (i) domestic and international merger and acquisition transactions, having represented primarily privately-held middle-market companies (and/or their owners) as sellers, and privately-held or publicly-held companies as buyers, in over 150 transactions, generally ranging in transaction dollar value from $10 million to over $1 billion, and (ii) transactional IP matters, predominantly with respect to identifying, protecting, and commercializing IP for both high tech and consumer product and service companies. The IP legal projects have generally consisted of assigning, licensing, and otherwise monetizing patents, copyrights (including software), trademarks, service marks, domain names, and trade secrets, as well as the sale and distribution of consumer products and services, and the building, extending (into other product/service categories), and expanding (both nationally and internationally) of consumer brands. Scott also is a successful inventor who through his company, Lochner Technologies, LLC, has successfully monetized his U.S. patents through agreements with nearly 30 large technology companies, including Apple, IBM, HP, Dell, Sony, LG, and Blackberry Limited, among others. From 2008 to 2012 Scott served on the Corporations Committee of the Business Law Section of the State Bar of California (and on the Subcommittee on Mergers and Acquisitions), and from 2017 to 2020 he was a member and served as an officer of the Executive Committee of the Los Angeles County Bar Association Business and Corporations Law Section.

*Inactive member.

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