# "Top Ten" M&A Deal Insights From Leading CEOs, CFOs and VCs

## M&A Seminar Series: Key Tips From All Eight Sessions

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# Fenwick & West M&A Seminar Series Panelists

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**Session Eight: CEO View:**

Ben Horowitz, co-founder and former President and CEO of Opsware; Partner, Andreessen Horowitz venture fund
Dave Orton, former President and CEO of ATI Technologies; CEO Aptina Imaging
Tony Zingale, former CEO and President of Mercury Interactive and Clarify

**Session Seven: VC/Chairman/CEO/Founder View:**

Glen Antle, former CEO ECAD and Trident & Cadence founder;
Mike Child, MD, TA Associates;
Don Lucas, VC & Oracle and Cadence Board Member;
Jim Solomon, Cadence founder

**Session Six: Director/Executive/VC View:**

Ray Lane, Partner, Kleiner Perkins;
Ned Barnholt, former Agilent CEO;
Ray Bingham, partner General Atlantic and former CEO Cadence

**Session Five: VC/Board Member View:**

Ram Shriram, VC & Google founder;
Atiq Raza, former CEO NexGen and former CEO RMI;
Jim Hogan, VC & former SVP Cadence; Board member, Tela Innovations
Eric Keller, CEO Movaris, former Marimba Board member; COO Kleiner Perkins

**Session Four: CEO View:**

Rajeev Madhavan, CEO Magma;
Rich Wyckoff, former CEO Marimba;
John Sanguinetti, former President, Chronologic and Forte Design;
Charlie Huang, VC, former CEO CadMOS; SVP and Chief Strategy Officer, Cadence

**Session Three: CFO View:**

Mark Garrett, former CFO Documentum; CFO Adobe
Bill Porter, former CFO Cadence;
Greg Walker, former CFO Magma, CFO Innopath

**Session Two: Business Development Executive View:**

Mark Bailey, DFJ ePlanet partner, former SVP BD Symantec & Healtheon;
Greg Wagenhoffeer, Dir. M&A, Magma;
Michel Courtoy, former M&A VP Cadence & CEO Certess

**Session One: Investment Banker View:**

Tim Ng, Deutsche Bank;
Mike Kelly, Broadview;
Glenn Daniel, Houlihan

# M&A Seminar Series—Session Eight: CEO View:
## "Top Ten" M&A Deal Insights

Tony Zingale, Dave Orton, Ben Horowitz, David Healy

JANUARY 28, 2009

1. Build a Great Company First. Maximize valuation by building a great company (not just a great product) that is the leader in its market segment. You can become a market leader by buying companies to fill out your product suite, increase average sales per customer and improve your go-to market strategy (Cadence; Opsware; Clarify; Mercury Interactive) or by using M&A to expand into new markets (ATI; Opsware). The best deals help the buyer to start selling "business value" to customers' senior executives rather than "technology value" to their R&D or IT groups (Mercury Interactive). Shedding weak businesses (Loudcloud's web hosting business) or product lines (ATI's low margin graphics boards) to focus on core strengths is critical.

2. Evaluating Strategic Alternatives (Including Staying Independent). CEOs (and boards) must evaluate strategic alternatives as a way to expedite the maximization of shareholder value. In deciding whether to remain stand-alone, ask: Are we #1 in our market? Is our market large and growing? Will our market remain stand-alone? If yes, more value is generally created stand alone. However, if it becomes clear that you cannot become the No. 1 player in your market segment (Clarify vs. Siebel), or that the market will change (via consolidation, increased competition, or declining demand) in such a way that the upside is or may be adversely impacted (Loudcloud; Opsware), perhaps it is time to consider selling. In this regard, CEOs must ask tough questions about the strength of the management team, the strength of the company's product mix and the impact of new trends and should not assume "perfect execution". If you receive a cash bid that is clearly better than any risk-adjusted, projected stand alone value (Clarify/Mercury Interactive/Opsware), the board should maximize value for shareholders. It is imperative to "get big or get bought", because customers prefer to buy from the market leader.

3. Do a Market Check? Generally, it is best to maximize M&A valuation through a competitive deal process and by maintaining an ability to remain independent and thus having an ability to walk from the deal (Opsware; Clarify; Mercury; ATI). Sometimes, however, a thorough market check may not be possible, such as where a leak about the deal might upset a target's competitive situation or where there are only a small number of viable bidders (ATI). Often, strategic partner discussions will lead to M&A or make it easier to do a rapid market check (Opsware).

4. Determining Valuation. Macroeconomic factors should inform your assessment of your own valuation. Valuation is relative to that of peers and targets, and "markets can remain irrational longer than you can remain solvent", so don't wait for a market rebound to do a deal. Many deals are done for strategic reasons (ATI/AMD, ArtX/ATI, Opsware/HP; Mercury/HP), while others are done for defensive reasons (SGI/Alias Wavefront). Sometimes, the price is such that a target should accept the deal even though the business synergies are less compelling (Clarify/Nortel).

5. Negotiating Tips For Targets. Potential targets must: have a disciplined negotiating approach and stick to it; be truthful and consistent in their statements; focus on what is motivating the buyer (e.g., why the deal will help the buyer more effectively deal with its customer base); and maintain deal momentum (which may mean passing on slow moving bidders). Sometimes, you can maintain negotiating momentum by creating a valuation model and limiting discussion only to the assumptions. The target team must know more about the markets, competition, and its potential revenue upside than the buyer's negotiating team.

6. Comparing Bids. Targets that are comparing alternate deals that each provides for an earnout or the receipt of stock merger consideration should evaluate the long range success of each buyer, and the timing to liquidity, especially for target employees subject to continued vesting.

7. M&A Essentials. The deals that tend to be the most successful have good strategic fit, minimal product overlap, a good cultural fit and a price that is fair to both parties (so critical target team members are retained). In addition to these factors, the parties must focus on issues that will impact deal certainty. Cultural fit (including management style and work ethic) is often hard for a target to determine in advance. Companies with a more open communications style can more effectively overcome cultural differences. As to strategic fit, acquiring a top brand that has no synergy with the buyer's core business is less likely to be effective than a deal that leverages the buyer's technology, products and brand to enable it to grow out of its core business. If a deal is critical to a buyer's strategic objectives and will result in substantial top line synergies, it may make sense for the buyer to pay at the high end of the valuation range.

8. Importance of Being Great at Both Internal R&D and M&A. The best growth strategy is to combine strong internal R&D efforts with a robust M&A program so as to maintain market leading products (Clarify/Cadence). An effective M&A strategy requires an environment where risk taking is respected, not penalized.

9. Buyer's Channel as a ROI Driver. Buyers with a robust marketing and sales channel (Oracle; Cadence) can bring target products to market quickly, which can help drive revenue synergies and ROI and is a selling point to target CEOs who want their technologies to achieve market acceptance.

10. Integration Tips. Executives need to focus up front on integrating acquired companies. Emotions and broad public statements ("no layoffs") should be avoided as they are counter-productive and fast execution is critical. They key to successful integration is giving someone (optimally the target CEO) substantial authority to drive integration decisions, retaining key target employees, and motivating the target team members to focus on achieving the buyer's (not the target's prior) business objectives. Often, it is better to be crisp and decisive than to be "fair" or "right" in making integration decisions. Implement cost synergy plans (often involving layoffs) quickly, then set expectations and create alignment within the company. It is difficult to integrate a major acquisition and achieve strategic synergies (create new, combined products) when the buyer has weakness in its core business (SGI/Cray).

Link to more detailed Summary of Panelist Interviews and Panel Transcript:
http://www.fenwick.com/docstore/Publications/Corporate/M&A_Sessions/COMBINED_Ses8_Top_Ten_Summary_Transcript.pdf

# M&A Seminar Series—Session Seven: VC/Chairman/CEO/Founder View:
## "Top Ten" M&A Deal Insights

Glen Antle, Mike Child, Don Lucas, Jim Solomon; Dave Healy

MARCH 13, 2007

1. A Successful Merger of Equals is Possible: Valuable lessons can be learned from the successful ECAD/SDA merger, which eventually led to the formation of Cadence, the leading company in the market for electronic design automation ("EDA") software. The ECAD/SDA merger was unique because it was a true "merger of equals" in which the management and board of the new company were split equally between ECAD and SDA representatives. The following factors contributed to the success of this rare form of merger: (i) the two corporations had complimentary growth strategies and products: ECAD was public with a strong, slow-growing product while SDA was a private company that had missed the IPO window by a single day but had a fast-growing, profitable product; and (ii) there was a lack of ego at the top: the CEO of ECAD was willing to compromise regarding his role in the new company and was willing to reach out to the acquired corporation personnel to make them feel integrated.

2. Avoid a Narrow "NIH" ("Not Invented Here") Attitude: A NIH syndrome refers to companies' reluctance to buy technology not invented internally. Companies should avoid this approach and instead evaluate the success of an acquisition based on the following factors: (i) quality as the #1 factor: focus on acquiring high quality software engineering and products rather than developing products internally; (ii) acquire companies with manageable costs of integration: avoid buying companies that would take an unreasonably long time to be absorbed, even if the deal would allow you to enter into a new market segment; and (iii) look beyond the financial benefits of the acquisition: although half of the acquisitions that Cadence made arguably did not make sense financially, the other acquisitions that were successfully integrated were critical to Cadence's continued growth.

3. Benefits of Merging Competitors. Merging competitors (PiE/Quickturn) improves the quality of their products due to synergies from combining their core strengths, combines the strength of their IP portfolios and (where there are infringement issues) reduces risks and costs related to IP litigation. "The benefits of competition are over-rated."

4. M&A Synergies for Fast Growing Companies. The combination of a solid acquisition strategy and robust organic growth can lead to significantly enhanced shareholder returns.

5. Keys to a Successful M&A Strategy. Key elements of a successful M&A strategy include: (i) having a business development group that is separate from operational management, which can lead to a more objective and efficient evaluation of M&A deals (Oracle); (ii) making personnel decisions before the deal closes to quickly establish certainty (Siebel); and (iii) the buyer CEO's demonstrated commitment to the integration of both companies (Siebel and Datek) and to ensuring cultural fit by making the acquired company feel as an integrated part of the new entity (ECAD/SDA).

6. Earnouts. An earnout may be the most sensible way to price a deal when the target has little or no revenues. Although earnouts can lead to increased retention of target employees, they can create different incentives between target and buyer employees.

7. "Gaming" Exchange Ratios/Collars. Don't try to seek an unfair advantage by "gaming" the exchange ratio or collar by predicting how the trading price(s) will move—it's too hard—instead do what's fair for both parties because that's the best way to get the deal closed. These fluctuations should be "in the noise" in your transactions.

8. Advice to Start-Up Founders: Some tips for start up CEOs include: (i) find a narrow area of expertise where there is opportunity for large improvement because the market place is not yet mature, and then use M&A to achieve rapid growth through the acquisition of new technology; and (ii) pick the right market segment: some market segments such as EDA and software as a service (SAS) offer great opportunity for start-ups, whereas the ERP and semiconductor sectors are tougher areas to enter today, especially given the strong semiconductor competition coming from China.

Link to more detailed Summary of Panelist Interviews and Panel Transcript:
http://www.fenwick.com/docstore/Publications/Corporate/M&A_Sessions/Ses7_Summary_Transcript.pdf

# M&A Seminar Series—Session Six: Director/Executive/VC View:
## "Top Ten" M&A Deal Insights

Ray Lane, Ned Barnholdt, Ray Bingham, Dave Healy

MAY 4, 2006

1. Internal Growth vs. M&A. There are several reasons to choose M&A rather than internal growth as a strategy: (i) by accelerating the time to market of new products, M&A can help companies quickly build a position of technological leadership in a fast-changing market sector (Cadence; Agilent); (ii) M&A can help a company fill gaps in its strategic plan to reach a better market position and to acquire better technology and talent (Agilent; SAP/Virsa); (iii) for an established company in a maturing industry, M&A offers the opportunity to move into an adjacent market where the company can leverage its existing sales channels (KLA/ADE); and (iv) a mid-size company can use M&A to survive in a slow-growing market by stimulating continuous innovation through the acquisition of smaller companies with innovative products that will bring renewed revenue streams (Quest Software). A growth strategy is not fixed and a company should be open to changing its strategy at any time in light of external market conditions, internal performance and potential for organic growth (Oracle).

2. Effects of Industry Trends on M&A Strategy. M&A strategy must be tuned to your company's market segment. For example, in the enterprise software industry, where the mantra is "innovate or dominate", it is expected that there will be an aggressive restructuring in the next few years. In this restructuring, companies that are not start-ups with fundamentally innovative products or dominant industry leaders with continuously innovative products will have no choice but to resort to a strong M&A strategy if they want to survive. In the electronic design automation (EDA) industry, which is a small industry with large, slow-growing industry leaders, the opportunity for growth started to appear limited; this trend led to two M&A strategies in the EDA field: M&A as a way to change the existing business model and M&A as a way to explore adjacent markets. In the medical device industry, increased customer consolidation and heightened competition from industry giants (GE, Siemens) resulted in very narrow margins, which were not sufficient to justify investing in an aggressive M&A strategy; these market conditions led to Agilent's divestiture of its medical device business to focus on other areas.

3. Advice to Founders on When to Sell. An entrepreneur should consider selling his company when: (i) the company reaches a point where it needs capital to grow and expand; (ii) the company's product is currently innovative but will eventually be produced by dominant players in the field (Virsa); or (iii) the company is not growing anymore and is breaking even (Marimba).

4. Metrics to Evaluate M&A Deals. In order of importance, consider these four categories of metrics when evaluating an M&A deal: (i) strategic fit metrics: focus on the long-term synergy and sustainability that the deal can bring; (ii) operational fit metrics: evaluate geographical, cultural and sales force issues that could prevent integration; (iii) financial fit metrics: evaluate traditional financial metrics (accretion, dilution, return of investment) in light of the strategic and operational fit of the deal; and (iv) cultural fit metrics: evaluate the need to retain the target workforce, which is sometimes necessary to sustain the new technology acquired. The CEO plays a crucial role in achieving successful cultural integration by clearly defining the roles of the new employees and products in the entity to avoid external and internal confusion.

5. Evaluating Spinoffs and Divestitures. The following three conditions suggest the advisability of a spin off: (i) the two entities have very complex and different business strategies that cannot be reconciled (HP/Agilent); (ii) the spinoff would create additional value for the shareholders of the larger entity; and (iii) the spinoff would have a sustainable customer base (Cadence/Tality).

Link to more detailed Summary of Panelist Interviews and Panel Transcript:
http://www.fenwick.com/docstore/Publications/Corporate/M&A_Sessions/Ses6_Summary_Transcript.pdf

# M&A Seminar Series—Session Five: VC/Board Member View:

## "Top Ten" M&A Deal Insights

Ram Shriram, Eric Keller, Jim Hogan, Atiq Raza, Dave Healy

june 8, 2005

1. Target Board Process. The record should demonstrate that the target's board fully vetted all the relevant alternatives, including staying independent, and was committed to maximizing shareholder value. That will help avoid, or enable efficient settlement of, M&A-related litigation against public target directors. In evaluating whether a premium is sufficient, the target's board must look at the big picture. What are the history and long term prospects of the company, how successful has it been, what is the board's confidence that the company can perform against its current operating plan and strategy and that doing so will drive stock value, and is a low market capitalization over a long period a fair assessment or a temporary anomaly? A good board member will help identify and evaluate strategic alternatives, ask the right questions and insist on a good process and a fair valuation.

2. Target Board Role. Target directors who know the buyer's executives or directors can play a critical role in creating the credibility and comfort needed for the buyer to take the "leap of faith" required to move to the high end of the buyer's valuation range. But the target company must speak with only one voice, which must be that of its CEO.

3. Target M&A Counsel Role. Good M&A counsel can guide board members on issues that are vital to establishing a good board process, which is important for litigation risk management, especially in terms of advice on fiduciary duties, market deal terms, and the amount of "shopping" required. "Deals are like having a baby, you can read a book about it, but you want an expert around when it happens."

4. Buyer Board Role and Process. The buyer's board must ask tough, high level questions. Is there a vision match, are there end user benefits, is there a good strategic fit, will this deal help the buyer, what are the channel synergies and integration risks? The buyer's board must dig deep to understand the defensibility of the target's products and technology, the nature of the target's talent pool and the buyer's ability to retain the key target employees post-deal. The board must help management understand it cannot "acquire" its way out of a problem and that buyers often overpay, overlook strategic fit problems and underestimate integration issues. The board must help management walk away from deals that don't make sense, and willingness to walk will help the buyer negotiate deal points. The buyer's board must make clear to target management that it will be held accountable to deliver an acceptable return on investment (ROI) on a deal.

5. Strategic Fit: Criticality of End User Benefit and Target Employee Retention. The history of acquisitions by larger public companies in the Internet and e-commerce space in particular suggests that a good rule of thumb is to only make acquisitions that truly add end user benefit; if they don't, don't do them – every other consideration is secondary. Especially in the Internet space, which is a war for talent due to the short code development cycles, buyers must focus hard on retention issues.

6. Criticality of Profitability to M&A Valuation. If you want to sell your company, first focus on becoming profitable (or at least on demonstrating a path to profitability) so the buyer's P/E ratio can be a driver of deal valuation, and [threatened] IPO and M&A alternatives are more realistic. If profitability can be achieved, then the target can pick the best time to maximize valuation in a sale, rather than having the timing dictated by the lack of operating capital.

7. Evaluating the Stand Alone Alternative. Where a private target concludes there is no logical acquiror, and it faces an uncertain long term future as an independent company due to the prospect of increasing competition, lack of sufficient cash or lack of revenue momentum, the "stay independent" scenario is difficult for the board to evaluate and it is much more difficult to determine the right time to sell or the right method of conducting a market check. This is particularly true where the only logical buyers are competitors, who might be tempted, despite an NDA, to start rumors about the target being for sale or "non-viable".

8. Certainty/Valuation Tradeoffs. Often the directors of a private target will agree to "lock" the deal to give the buyer deal certainty, and in exchange the target will demand a higher valuation and seek to eliminate the buyer's ability to "walk" from the deal based on open-ended closing conditions. Directors are often concerned about the risk of being sued for making this tradeoff, as it may preclude their consideration of a subsequent unsolicited bid. The case law in this area gives directors guidance as to the extent to which they can "lock" the deal, and the extent to which shopping is required. Agreeing to a "no shop" is significant, because the leverage of multiple bids helps both in maximizing both deal valuation and the liquidity of consideration and in ensuring, on the private target side, that indemnity and escrow provisions are not over-reaching. Ideally a public target sets up a process to obtain a bid, and then has time to do a quick and efficient market check before signing a "no shop" agreement (and obtaining a "standstill" agreement from the buyer in return).

9. Liquidity/Valuation Tradeoffs. Comparing cash vs. stock bids is difficult, and may present both certainty/valuation and liquidity/valuation tradeoffs, and either choice (a higher stock bid or a more certain, but lower, cash bid) may be challenged in litigation. A disadvantage of taking cash is that the board has a clear obligation to shop the company and get the best price reasonably available. In evaluating a stock deal, the board members should keep in mind that as fiduciaries, the proper question to ask is, what is the stockholders', not the board members', risk appetite.

10. Addressing Litigation and Retention Concerns in Low Valuation Deals. Sorting out director responsibilities can become particularly difficult in evaluating a proposed private company merger in which the valuation is so low that common stockholders and optionees will realize almost nothing due to the liquidation preferences of preferred stockholders. In that case, the board and majority stockholders must strive to structure an M&A deal that is best for all equity holders, which can often be a challenge. The litigation risk in this situation is heightened if there were earlier financing rounds that heavily diluted the common without giving them an opportunity to invest pro rata. A related problem that arises when attempting to sell private companies that have a large liquidation preference in favor of venture investors is that there is little deal value available to incentivize founders and optionees who will be continuing employees; in that case, the buyer may force a recapitalization to re-allocate merger proceeds, or require that some of the deal value be allocated to retention bonus pools for the benefit of former target employees, to ensure that continuing employees will be motivated. This can be a difficult issue for the target board.

Link to more detailed Summary of Panelist Interviews:
http://www.fenwick.com/docstore/Publications/Corporate/M&A_Sessions/Ses5_Summary.pdf

# M&A Seminar Series—Session Four: CEO View:
## "Top Ten" M&A Deal Insights

Rajeev Madhavan, John Sanguinetti, Rich Wyckoff,
Charlie Huang, Dave Healy

MAY 18, 2005

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1. R&D, M&A or OEM Channel as Optimum Growth Strategy. Internal development is often best if you have the skills and resources to make a competitive product, as it is usually cheaper, faster and better integrated with existing products, so long as the development does not impair your ability to remain profitable, but that approach is viable only if the development can be completed in time to release product within the applicable market window. Conversely, if a third party has technology outside of a company's core area of competence, and the potential buyer does not have the internal skills to develop that technology, and the buyer can obtain a R&D team without adding much G&A cost or creating difficult product integration issues, buying that target is clearly the best approach. Large companies' R&D efforts may be constrained by a lack of profitability, or due to concerns about creating compatibility and support issues, so they often must acquire start ups for the most innovative technologies. OEM deals can give access to a new product or channel, but they often prove to be non-optimum over time due to the parties' changing priorities. An inquiry from a larger company about a potential OEM deal may actually be a disguised "fishing expedition".

2. M&A vs. IPO. An acquisition at a fair price is often a far quicker way to liquidity and locking in stock gains than an IPO. Many public technology companies do not manage to keep their trading price above their IPO price over the long term. Thus, given lock-ups,volume restrictions and trading blackout windows, founders and VCs with a substantial equity stake have trouble liquidating as fast as is desired. This problem is compounded by market volatility and the risk of a blown quarter. In contrast, however, sometimes a company has not demonstrated its true upside potential, so a merger valuation would not be optimized, and it is better off completing an IPO, performing against plan, and driving the trading price up over time, then evaluating whether to stay independent or sell out at a premium to the trading price. An advantage of waiting to sell until after an IPO is that public acquisitions usually have no indemnity or escrow provisions, and shopping is not only expected but more clearly required, which helps drive deal valuations.

3. "Rules of [M&A] Dating". All rules of dating apply to M&A—(i) you can't look too anxious, (ii) you can't be too easy; (iii) you will drive yourself crazy if you wait by the phone, (iv) there is a lot of strategy as to who makes the first call; and (v) dress up, but act like you don't care.

4. Keys to Great Deals. The best M&A deals generally have the following five characteristics, in this order of importance: strategic (long term) fit that leads to building critical mass; complementary products, cultural fit, geographic fit, and a deal that is a financial win-win for both parties (i.e., if either party resents the deal terms, then it won't be a great deal). Clarity and speed are also critical to M&A success, because the longer it takes to get the deal done, and the more ambiguous the communication, the more confusion is created.

5. Selling the Deal to the Buyer's Board. It is critical to lay out for the buyer's board why the deal is essential and can't be done by internal R&D, the long term and short term strategic value, why the technology is a good fit, and why the integration plan makes sense and will achieve the desired synergies. Then it's up to the buyer's CEO to achieve the metrics promised to the board for the deal. In general, a buyer's stock trades down, not up, when it announces a deal, so the buyer's CEO must deliver on long term guidance to Wall Street and look to be rewarded over the long term.

6. Determining a Fair Price. Bankers will advise the target's board how the proposed deal valuation compares to the range of fair values for each valuation methodology metric (such as prior and projected revenues and EBITDA, market multiples and comparable transaction multiples). One difficult issue is where the best price that can be negotiated is at the low end of several fairness ranges, but within the range of the majority of the metrics. In that case, the board must rely on the banker's fairness opinion, a thorough market check and the board's considered best judgment as to the valuation's fairness, but realize that this situation is grist for M&A litigation.

7. Stretch M&A Valuations. If a deal is highly strategic, and has a large revenue upside in a key new area, it makes sense for the buyer to accept EPS dilution over a long period to invest in that upside, even if the buyer's trading price is initially adversely affected. The buyer's CEO and board must have the courage to do dilutive deals that offer tremendous upside. Where there is a valuation gap, it is critical that both sides converge on a reasonable view as to the revenue synergies the target will bring and a fair means of sharing synergies.

8. Valuation Tactics and Missteps. The best way to optimize value for the target is to persuade the buyer as to the target's revenue potential. The real persuading is done on a CEO to CEO basis and it requires a leap of faith. The best way for the target CEO to persuade the buyer as to valuation is to have quality customers and repeatable revenues. A target CEO can lose a deal by over-negotiating, over-promising or misperceiving the perceptions of the buyer's board.

9. M&A Timing. The optimum time to sell your company is when: (i) you have had two to four quarters of sequential revenue growth, (ii) you are on the curve of a rapid take off and can demonstrate that momentum will continue, and (iii) you have a product that is ready to be pushed through a big distribution channel. You may be forced to sell when: (a) you are on the brink of having to scale and you don't have the cash to scale (and you know that raising the cash will result in significant dilution), (b) you are running out of sales bandwidth and infrastructure, sales channel, and QA capabilities or (c) there is substantial industry consolidation, producing a risk that all of the target's competitors will align with larger industry players, leaving the target as the "last party standing at the dance without a dance partner."

10. Driving Your Team to Closure. It is critical for both parties to have deal teams (including bankers and M&A counsel) that have the business judgment to negotiate deal terms creatively rather than being so aggressive or over-protective as to risk derailing the deal. The respective CEOs should digest counsel's advice on the risks, and then make clear to their respective deal teams that they understand that risk and want to move forward (with an agreed level of deal or indemnity protection, or not).

Link to more detailed Summary of Panelist Interviews:
http://www.fenwick.com/docstore/Publications/Corporate/M&A_Sessions/Ses4_Summary.pdf

# M&A Seminar Series—Session Three: CFO View:
## "Top Ten" M&A Deal Insights

Mark Garrett, William Porter, Gregory Walker, Dave Healy

APRIL 20, 2005

1. Valuation Process. Before an acquirer starts merger negotiations, it is critical that it determine what it believes the target is worth on a stand alone basis as well as on an as-merged with cost and revenue synergies basis. The buyer is then armed for the target's later push to share the benefit of synergies. A buyer's board may set a valuation threshold, such as that deals must generally be accretive within 2 quarters, at least on a pro forma basis, to be approved, which will in turn drive the valuation negotiations. Buyers will sometimes do deals that are initially dilutive, if they are strategically important. The target's bankers will compute the maximum valuation that the buyer can pay and still have the deal be accretive immediately or within a specified number of quarters. Where deals are projected to be dilutive on a GAAP basis solely due to a technical accounting reason, such as deferred compensation or variable award charges or a write-down of deferred revenues, analysts will usually be supportive of the deal. It is important to use a comparable companies' analysis to understand how the market is valuing a public target, then determine what assumptions are built in to that analysis and how that compares to the buyer's internal analysis. The key is to understand what assumptions as to projections and synergies must be true to achieve each level of deal value, and understand what the buyer has to do to achieve and deliver those projections and synergies and what the execution risks are.

2. Valuation Negotiation Tactics. Target tactics for driving valuation include: (i) having other interested parties; (ii) being willing to walk; and (iii) helping the buyer's team to create an aggressive but achievable model, realizing that it will become the target's post-merger operating plan. Buyers sometimes use issues such as improved deal certainty, upside through an earnout or use of the buyer's stock as currency, and the value of the buyer as a platform for the target founders' careers and the target's technology, as a means to persuade founders to accept one bid over another one that is nominally more valuable. Another approach is for the buyer to ensure that the target understands that a public buyer needs to have a valuation that makes sense in terms of applicable market revenue and EPS multiples, not just as a multiple over the last VC round valuation.

3. Bridging Valuation Gaps. Where the parties have a disconnect on valuation based on the target's perception of its future projections, the first step has to be to make sure that the buyer understands how the target is estimating its projections, and what the assumptions were, and make sure the target understands in detail how the buyer views the target's projections. This usually results in the parties coming much closer to a mutual understanding as to the target's realistic projections, which usually narrows the differing views about valuation. In the end, how much the parties are willing to compromise on valuation is often a function of the target's and the buyer's "next best alternative" to the deal, whether the buyer views the deal as defensive or offensive, and whether the bulk of the consideration is going to the key R&D team members thus incentivizing them to perform. Where the buyer is pushed on valuation to the top of its range, it has to evaluate what assumptions must be true to achieve that negotiated valuation viewed from a bottom's up analysis, and then ask the tough questions as to achievability of those assumptions. It is critical to have multiple negotiating channels, and to also have a back-channel means of resolving negotiating logjams, usually CEO to CEO or CTO to CTO, because it is usually easier to compromise in back channel discussions than in open negotiations. Negotiating valuation is an iterative process, and it usually cannot be done in one session. It is critical for the buyer to understand the capitalization structure of the target, and to determine the deal value at which the key target employees will meaningfully participate in the deal proceeds, which is usually the minimum price for opening deal negotiations.

4. How To Sell the Deal to Wall Street. As with the CFO's dealings with the board of directors, it is often useful to lay the groundwork with analysts well in advance of any particular deal as to the buyer's M&A strategy, so when a particular deal comes up, less education is required as to strategic fit. Analysts will want to understand when the buyer believes the deal will become accretive, and what the underlying assumptions of that analysis are (e.g., as to revenue and cost synergies), and why those are reasonable.

5. Managing the Buyer's Board. Tips for the CFO on how to help the buyer's board through the M&A process include: (i) educate the board well in advance as to the buyer's strategic product roadmap, so board members are pre-sold on the need for acquisitions in certain key technology areas; (ii) show the board how a particular deal fits into the long term strategy; (iii) in terms of financial analysis, lay out the assumptions so the board understands how management views valuation, what the assumptions are and why management believes those assumptions are reasonable; (iv) follow a consistent deal process and presentation format, so the board can focus on the key issues (which might include a summary of deal terms, strategic analysis, financial and valuation analysis, major assumptions and a summary of deal risks); (v) help the board understand the post-closing assumptions and integration steps critical to achieving the expected value of the deal to the buyer; (vi) prior to the final board meeting approving the deal, have a series of one on one conversations with board members to solicit their input and reflect that input in the analysis and presentation of the deal and the deal negotiations so the board's concerns are addressed in advance; (vii) anticipate detailed board questions, and have detailed backup as to anticipated questions; (viii) keep the board updated on negotiations, and where possible have board members meet key target founders and executives; (ix) make clear to the board who the executive sponsor of the deal is; and (x) give the board a report on a regular basis as to how past acquisitions have performed on a financial and operational basis, with suggestions for improvements on how to handle future deals.

6. Tracking M&A ROI. As noted, track the performance of each M&A deal post-closing and hold the executive sponsor accountable if there is a failure to achieve the expected performance. If you don't track performance and use a standard review approach as noted in point 5 above, you may have a valuation disconnect and overpay.

7. Managing the Seller Board's Process. Key elements of dealing with the board on the sell side, where the burden of showing "due care" is greater and the risk of litigation against directors is greater, include: (i) plan for multiple board meetings to evaluate the deal and alternatives to the deal; (ii) know how to quickly reach each director (it may be fatal to a deal if the target can't achieve a unanimous board vote at a critical juncture); (iii) as on the buy side, have frequent one-on-one discussions with board members to pre-sell them and get their informal input; and (iv) create multiple viable alternatives, and have a process that helps the board fully evaluate each alternative (including that of staying independent).

8. Keys to Successful M&A. Generally speaking, deals are more likely to be successful where: (i) there is a clear reason for doing the deal and a clear fit with the buyer's long term strategy; (ii) the integration process was managed in a manner that fit with that strategy and rationale; (iii) the deal had an executive sponsor within the buyer who was accountable for the achievement of the anticipated benefits of the deal; (iv) the tough operational decisions after closing (like RIFs and other cost savings measures and eliminating overlapping products) are made quickly but in a manner that does not disrupt the business; (v) any earnout is structured in a manner that is consistent with the buyer's long term business objectives; and (vi) the buyer actively monitors performance of its deals, to help it learn from past mistakes and adjust terms of future deals accordingly.

9. Earnout Advantages. The benefits of earnouts include: (i) it helps bridge a valuation gap when the negotiations get bogged down, which can accelerate negotiations, although trying to anticipate all future earnout issues can slow the negotiations; (ii) it puts the burden on the target team to timely deliver the promised products and bookings, which incentivizes and focuses the target's R&D and sales teams in particular; (iii) earnouts are often easier to analyze and present to the board and analysts, because there is less risk of overpaying when the earnouts are tied to future bookings; and (iv) of necessity, earnouts require that the parties trust each other and reach a shared understanding that if unanticipated issues come up, they will be dealt with fairly and by an agreed resolution process, so the earnout discussions can be a good means of determining when that trust and cooperative working relationship is there, and when it isn't (in which case, the buyer should walk from the deal.)

10. Earnout Pitfalls. Disadvantages of earnouts can include: (i) it is difficult to anticipate every issue as to which there will be a future ambiguity, resulting in disputes or difficult future negotiations; (ii) earnouts are difficult to negotiate and administer; (iii) often, earnouts leave the target employees incentivized to take actions that turn out to be inconsistent with the buyer's long-term company-wide goals; (iv) products tend to blur over time, making measurement difficult, especially for software; (v) the target will often seek to blame any failure to achieve earnout milestones on budget or synergy shortfalls; (vi) new hires into the target's business unit can be difficult, as they come to resent the differences in overall compensation between otherwise similarly situated employees; (vii) revenue-based milestones can be much more complicated than bookings-based milestones due to the complexities of revenue recognition, and operating income based milestones present even greater complexities; and (viii) provisions designed to let the target operate independently post closing, or that give firm assurances to target executives as to continued employment, can result in a lack of operational flexibility that can result in a misalignment of goals.

Link to more detailed Summary of Panelist Interviews:
http://www.fenwick.com/docstore/Publications/Corporate/M&A_Sessions/Ses3_Summary.pdf

# M&A Seminar Series—Session Two: Business Development Executive View: "Top Ten" M&A Deal Insights

Mark Bailey, Michel Courtoy, Greg Wagenhoffer, Dave Healy

MARCH 23, 2005

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1. Identifying Optimal Targets. Each deal should to tie in to the overall long-term strategic plan. The plan should take into account normal competitive issues such as areas where your product suite needs to be filled out and customer input on new products, technologies and features needed. A deal may be attractive for both strategic reasons (in terms of fit with technology vision) and tactical reasons, such as meeting a competitor's advantage, or addressing an expressed customer need. A target may have a position in a particular market segment where the buyer does not currently participate, or may have technology that is more robust than that of the acquirer, or may be in an adjacent market that is a natural path for expansion. The acquirer must target acquisitions that let it build on the acquirer's core competencies to take advantage of new opportunities in the marketplace.

2. Persuading the Target to Sell. The key to persuading the target board members to sell for stock consideration is to convince them that the two businesses have the synergies to succeed, and give an upside that is better than the stand-alone scenario. It is important for the buyer to persuade the target that the buyer is committed to treating customers, employees and shareholders properly and that the parties share a common vision. Venture investors' primary concerns are valuation, liquidity, opportunity cost and exposure beyond the escrow. In any negotiation, it is critical for the buyer's team to look at who has the negotiating leverage at the target and focus the team's energies there. When the IPO window appears closed, most founders of and venture investors in private companies plan for an M&A exit and don't need much persuading, if an agreeable valuation can be reached and the buyer is not overreaching as to indemnity protection. As to public targets, if their market cap is modest, or an additional cash infusion is required for them to ramp, they will often find that an acquisition with a 30-40% premium is a highly attractive alternative.

3. Negotiating Valuation. As to whether the benefit of synergies should be shared in determining valuation, it may make sense to share the benefit of negative synergies (cost savings), such as the elimination of the target's G&A expenses, but buyers are often reluctant to share positive synergies relating to the benefit of the buyer's channel and of combining products, technology and people, as the buyer often believes it is bringing these synergies to the table. In determining deal value, the key is to always tie each valuation to specific revenue and expense projections, and always test those, to make sure the valuation is conservative and sustainable. Only add in the benefit of synergies if they can be quantified in terms of near term benefit. Adjust valuations based on your deal history. Buyers must be cautious as to how the target positions projections. Sometimes, the target will exaggerate projections to maximize the value of a fixed deal, or, for earnouts, the target might even understate its projections so the earnout milestones (e.g., a "minimum bookings threshold" above which the earnout applies) are set at a lower level.

4. Scope of Term Sheet. In general, the private target's leverage declines after it signs a no shop, so the target will often be best served by having a more detailed term sheet that covers the key economics, deal certainty, escrow percentage and term and indemnity cap and survival terms. Buyers can also benefit from winning key points (such as that escrow is a non-exclusive remedy) in a term sheet, as that will likely reduce subsequent negotiating time, but buyers often have more leverage at the agreement stage. Public-public deals usually have a generalized deal summary (with some key terms left open), not a letter of intent, to minimize the need for disclosure, but public targets should try to reach early agreement on ensuring deal certainty and ability to respond to unsolicited bids. If a target knows that some issues may surface in diligence, such as a potential IP claim, or a third party consent that will be difficult to obtain, it is often best to disclose that point before the term sheet discussions, and resolve that matter in the term sheet negotiations, so it is not used later as an excuse to lower the deal value.

5. Indemnity/Escrow Terms. Whether particular proposed indemnity and escrow terms are "market" in a public-private deal depends on relative bargaining leverage, the risks identified in diligence, the complexity of the target and the deal value. Arguably, typical terms are: an escrow of 15-20% of deal size that survives for 18-24 months and that is the sole remedy as to "normal" claims but a non-exclusive source of recovery for special claims like those related to capitalization, due authorization and tax, and as to those special representations, the right to seek indemnity for at least 3-5 years by recovering some meaningful percentage of the purchase price, which may ramp down over time. The indemnity basket (or deductible) is usually 1/2 to 1% of the purchase price. These points are often the last issues resolved in negotiations.

6. Coordinating the Deal Team. It is critical to keep communication open with your executives so all involved in the acquisition and integration effort are on the same page, especially in terms of timing and as to a consensus that the deal is worth the effort. It is critical to have all of the internal groups well coordinated, including R&D, HR, legal, tax, finance, and sales. Frequent meetings are critical. The key is to bring all the important parties together very quickly after merger is completed and to prioritize the high level integration plan.

7. Buyer Board Management. As to board management, it is critical for the deal team to have the board involved early and often and to keep the CEO updated to enable the CEO to brief the board. Having board members help on deal process helps executives sell the rest of the board on the vision and need for the deal. Pre-selling the board on all potential targets can speed the approval process. The board needs to understand the strategic rationale, the basis for the valuation, what the tough negotiating issues are and how the resolution of those issues might impact the deal terms and upside. The board package should start with a high level summary, then add increasing levels of detail so directors can dive in as much as they desire.

8. M&A Deal Breakers. It is best to walk from the deal where (i) IP rights are unclear; (ii) the target has a poor reputation for technology excellence or delivery, (iii) there is a lack of candor from target management, (iv) potential litigation liabilities cannot be adequately addressed by valuation adjustments or escrow/indemnity provisions; (v) there is an unduly high target preferred liquidation preference that leaves little deal value for continuing employees, leaving them unmotivated, and investors won't stand back from their preferences to some extent to remedy that, (vi) the target insists that the escrow fund is the exclusive remedy in all cases (e.g., fraud), (vii) a private target refuses to deliver a "locked" vote, or (viii) the target insists on an excessive valuation.

9. Earnouts Benefits. Earnouts allow you to bridge the valuation gap between what the buyer is willing to pay and what the target is looking for, which is often a function of what the target perceives to be its other liquidity alternatives and its ability to remain independent without additional financing. Earnouts also serve as a valuable retention mechanism, since employees know that unless they remain aboard to help the acquired target business unit achieve the technology and product release milestones, the earnout is not likely to be earned. Earnouts also help smaller acquirors compete with larger acquirors that can offer higher fixed cash amounts. Earnouts can work well when there is a small group of target stockholders and the milestones are based on technology or product release milestones.

10. M&A Litigation. The board of a public target should assume that "strike suit" litigation will be filed. These suits can often be settled rather inexpensively if the target has established a good record of having shopped the company, openly and fairly considered all strategic alternatives and avoided any self dealing. There is tension between this type of litigation, which forces shopping to be maximized, and many buyers' refusal to spend time negotiating a deal until a no shop is signed.

Link to more detailed Summary of Panelist Interviews:
http://www.fenwick.com/docstore/Publications/Corporate/M&A_Sessions/Ses2_Summary.pdf

# M&A Seminar Series—Session One: Investment Banker View:
## "Top Ten" M&A Deal Insights

Mike Kelly, Tim Ng, Glenn Daniel, Dave Healy

FEBRUARY 23, 2005

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1. M&A Timing. Sell your company while it is still opportunistic rather than an imperative. Optimum timing for a private company may be where it does not have a near-term financing need and it is far enough away from the previous valuation that it has had the time to create more momentum. If you are approached by one of the dominant players in your market segment, consider that bid carefully, as if you spurn the inquiry, you can expect that the inquiring company will soon become a competitor. A "dual-track" M&A processes makes far more sense when the "second-track" is an IPO (and the company is a realistic IPO candidate) than when the second track is another private (down value) round.

2. Valuation Methodologies. Bankers typically use comparable public companies analysis (multiple of revenue, EBITDA, net income), comparable transactions analysis (multiples of last twelve months and next twelve months revenues), accretion/dilution analysis and discounted cash flow (DCF) analysis.

3. Timing of "Best and Final" Offer. If you think another bidder will emerge or an auction is involved or you expect that the target will shop the deal, it makes sense to leave room to move the price up. A record of upward price movement through negotiations is critical for the target board to demonstrate it satisfied its duty of due care, so the buyer will want to accommodate that. Also, the optimum record for the target board may be to give up some negotiating demands in order to obtain a more certain deal at a higher valuation. A target must realize that the bidder that appears to have the highest bid may in fact lower that bid (or raise new demands for unreasonable indemnity terms) after diligence, so sorting bids pre-diligence is risky. From this perspective, targets are well advised to do e-rooms of all diligence materials, let various interested parties all do their diligence at once, and then compare bids.

4. Shopping The Deal. The key is to identify likely buyers, their ability to pay, their strategic interest, their acquisitiveness, and any timing concerns (such as whether a potential buyer is distracted due to the need to integrate a recent acquisition), and then sort the potential bidders into Tier 1 and Tier 2 categories based on these factors, then have the target board buy in to which potential buyers to approach, and what the specific "pitch" is to each potential buyer. The shopping process will vary significantly depending on whether the target is public or private, pre-revenue or profitable and/or in need of funding. Shopping is most effective when at least two bidders engage. Unless the company has a relatively sizable revenue base and cash-flow (and is a candidate for a financial sponsor take-out), there are usually relatively few logical strategic buyers for any particular business. If the target has struck out with the Tier 1 list, it generally doesn't make sense to widen the net and extend the process, as that can be perceived as a sign of weakness. Extensive shopping can strain relations with customers and employees, and embolden competitors, leaving the target with no choice but to sell.

5. Adequacy of Deal Value. In order to assist the target board in evaluating whether it has complied with its "Revlon duties" and obtained the best price reasonably available in a cash merger, first the banker and the board must have used a process to identify and, if appropriate, approach all the potentially interested buyers. For technology companies, often the "best price" reasonably available can be the only price reasonably available because the number of logical and likely strategic partners is relatively low, so the board really needs to evaluate not only whether there is likely to be another buyer either now or in the future, but also what are the company's prospects "stand-alone" in the absence of the deal at hand and how might that impact the future appetite for acquiring the company.

6. Collars. "Collars" that adjust or limit the deal value can be difficult to negotiate. A target that is worried about a declining share value of the buyer may want a dollar minimum, whereas a buyer that has that concern may want to cap the number of shares issuable (e.g. so that the 20% stockholder approval threshold is not exceeded). A buyer concerned about rapid upward movement in its stock price may want to cap the dollar value of a deal. The key issue is what happens when you reach the cap—can a party walk or is the deal value subject to formulaic adjustment up to another outside "band". A collar should be flexible enough to anticipate that the buyer's stock frequently will trade down upon announcement of the deal then will trade up as the market learns about the synergies in the deal. A major concern with collars is that they encourage arbitrageurs to game the stock.

7. M&A and Appraisal Litigation Based on DCF Valuations. Contingency attorneys who make a practice of bringing M&A strike suits have noticed that in many appraisal cases Delaware courts have held that acquired companies are worth 1.5 to 2 times the negotiated M&A deal value, and much of that differential results from the court's reliance on discounted cash flow (DCF) analysis, which can produce a different result than other valuation methodologies and "reality based" deal negotiations. Given the increased M&A litigation risk in recent years, it may be critical for each public target to establish a strong record of having shopped the company and to ensure that the Board's discussions are vigorous and extensive and that potential conflicts of interest are carefully scrutinized and disclosed. Unfortunately, M&A litigation fails to recognize the reality that most technology companies don't lend themselves to "a process designed to maximize price." At most, the process is really designed to find a logical, willing buyer with the financial wherewithal to pay a premium for the company. Price maximization and "auctions" are more typically luxuries for sellers of reasonably "interchangeable, commodity" properties that throw off large amounts of cash. Those kinds of companies lend themselves to a meaningful DCF exercise. The DCF method is not as useful in valuing high-growth technology companies, since so much of the resulting DCF value comes from the terminal multiple, so a DCF valuation is actually more representative of a future assumed "take-out" of the business. Still, plaintiffs will often claim that a DCF valuation is "more reality-based" than an implied multiple of forward earnings or trailing EBITDA because it is a bottoms up representation of the company, but the numerous inputs imply a false sense of precision.

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