CHAPTER 5

Implementation: Search Through Closing
Phases 3–10 of the Acquisition Process

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Mergers, Acquisitions, and Other Restructuring Activities
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A man that is very good at making excuses is probably good at nothing else. — Ben Franklin

INSIDE M&A: WHEN PATIENCE PAYS—SIGNET JEWELERS TO BUY ZALES

KEY POINTS

• Having a clear business strategy makes target selection easier
• Approaching the target firm at the appropriate time with a compelling vision for the combined firms increases the probability of reaching a deal
• Friendly acquisitions often offer the greatest potential for synergy and shareholder wealth creation by promoting cooperation.

Signet Jewelers, a specialty retailer, announced it had signed a definitive agreement to acquire all of the outstanding shares of its smaller competitor, Zales Corporation, for $21 per share in cash in early 2014. The deal is valued at $690 million and $1.4 billion including assumed debt. The purchase price represents a substantial 41% premium to Zales’s closing price the preceding day. The size of the premium reflects Signet’s anticipated synergy with Zales.

Dallas, Texas-based Zales Corporation operates more than 1,000 retail stores and kiosks in the United States, Canada, and Puerto Rico. Its brands also include Gordon’s Jewelers and Piercing Pagoda. Its 2013 revenue totaled $1.9 billion. Hit hard during the 2008–2009 recession, Zales’s profitability plummeted, with the struggling firm recording a series of annual losses. The 90-year-old firm is in the process of completing its successful multiyear turnaround effort to restore profitability. Having delivered 12 consecutive quarters of revenue growth, the firm recorded a $10 million profit in 2013.

Signet, headquartered in Bermuda, operates more than 1,400 stores under the Kay Jewelers and Jared the Galleria of Jewelry brand names in the United States. It also operates about 500 stores in the United Kingdom under the brands H. Samuel and Ernest Jones. Signet’s CEO, Mike Barnes, said that the Zale deal fits perfectly with his firm’s strategy of expanding its domestic and international brand portfolio by making opportunistic acquisitions.

The deal substantially improves Signet’s geographic coverage throughout the United States and gives it access to additional well-known brands. The addition of Zale also gives
Signet its first presence in Canada, where Zales operates 199 stores under the Peoples brand. The deal also gives Signet access to several popular jewelry brands as well as those that have been exclusively sold by Zales, including Vera Wang Love and Celebration Diamonds.

The combined firms have annual sales of $6.2 billion. Signet intends to operate Zales under its current CEO, Theo Killion, who was responsible for the Zale’s turnaround. The merger is expected to increase earnings per share during its first full year of operation resulting from the elimination of duplicative overhead and the potential for combining retail outlets. Cost savings from combining the two firms are expected to total $100 million annually. Following closing, Signet will retain the Zale brand name.

Signet had been watching Zales’s successful turnaround with great interest for several years. Impressed with its management and how its geographic coverage and brand offering would complement Signet’s geographic foot print and brand offering, Signet approached Zales in late 2013 with a proposal to combine the firms. The proposal included a well-thought out business strategy for growing the combined firms and for retaining key Zale managers.

Signet’s patience paid off. Recognizing the immediate synergy created by combining the former competitors, investors applauded the deal sending Zale’s share price up 40%, while Signet’s rose by 9% on the news. Reflecting the effects of the firm’s successful turnaround, Zales Corporation’s share price has been up 208% compared to Signet’s 25% improvement in 2013 over 2012.

CHAPTER OVERVIEW

This chapter starts with the presumption that a firm has developed a viable business plan that requires an acquisition to realize its strategic direction. Whereas Chapter 4 addressed the creation of business and acquisition plans (Phases 1 and 2), this chapter focuses on Phases 3–10 of the acquisition process, including search, screening, first contact, negotiation, integration planning, closing, integration implementation, and evaluation. ¹ A review of this chapter (including practice questions and answers) is contained in the file folder entitled Student Study Guide on the companion site to this book (www.elsevierdirect.com/companions/9780128013908). The companion site also contains a comprehensive due diligence question list and listing of common sources of economic and industry information.

PHASE 3: THE SEARCH PROCESS

The first step in searching for acquisition candidates is to establish a small number of primary selection criteria, including the industry and the size of the transaction. Deal size is best defined in terms of the maximum purchase price a firm is willing to pay, expressed as a maximum price-to-earnings ratio, book, cash flow, or revenue ratio, or a maximum purchase price stated in terms of dollars. It also may be appropriate to limit the search to a specific geographic area.

¹For a detailed illustration of the M&A process outlined in this chapter, see DePamphilis (2011).
Consider a private acute care hospital holding company that wants to buy a skilled nursing facility within 50 miles of its largest hospital in Allegheny County, PA. Management believes it cannot afford to pay more than $45 million for the facility. Its primary selection criteria could include an industry (skilled nursing), a location (Allegheny County, PA), and a maximum price (five times cash flow, not to exceed $45 million). Similarly, a Texas-based manufacturer of patio furniture with manufacturing operations in the southwestern United States seeks to expand its sales in California. The company decides to try to find a patio furniture manufacturer that it can purchase for no more than $100 million. Its primary selection criteria could include an industry (outdoor furniture), a geographic location (California, Arizona, and Nevada), and a maximum purchase price (10 times operating earnings, not to exceed $100 million).

The next step is to search available computerized databases using the selection criteria. Common databases and directory services include Disclosure, Dun & Bradstreet, Standard & Poor’s Corporate Register, and Capital IQ. Firms also may query their law, banking, and accounting firms to identify other candidates. Investment banks, brokers, and leveraged buy-out firms are also fertile sources of potential candidates, although they are likely to require an advisory or finder’s fee. Such services as Google Finance, Yahoo! Finance, Hoover’s, and EDGAR Online enable researchers to obtain data quickly about competitors and customers. These sites provide easy access to a variety of documents filed with the Securities and Exchange Commission. Exhibit 5.1 provides a comprehensive listing of alternative information sources.

If confidentiality is not an issue, a firm may advertise its interest in acquiring a particular type of firm in the Wall Street Journal or the trade press. While likely to generate interest, it is less likely to produce high-quality prospects. Rather, it will probably result in a lot of responses from those interested in getting a free valuation of their own company or from brokers claiming that their clients fit the buyer’s criteria, as a ruse to convince you that you need the broker’s services.²

Finding reliable information about privately owned firms is a major problem. Sources such as Dun & Bradstreet and Experian may only provide fragmentary data. Publicly available information may offer additional details. For example, surveys by trade associations or the U.S. Census Bureau often include industry-specific average sales per employee. A private firm’s sales can be estimated by multiplying this figure by an estimate of the firm’s workforce, which may be obtained by searching the firm’s product literature, website, or trade show speeches or even by counting the number of cars in the parking lot during each shift.

Increasingly, companies—even midsize firms—are moving investment banking “in-house.” Rather than use brokers or so-called “finders”³ as part of their acquisition

²It is important to respond in writing if you receive a solicitation from a broker or finder, particularly if you reject their services. If at a later date you acquire the firm they claim to have represented, the broker or finder may sue your firm for compensation.

³A broker has a fiduciary responsibility to either the potential buyer or the seller and is not permitted to represent both parties. Compensation is paid by the client to the broker. A finder is someone who introduces both parties but represents neither party. The finder has no fiduciary responsibility to either party and is compensated by either one or both parties.
## EXHIBIT 5.1 INFORMATION SOURCES ON INDIVIDUAL COMPANIES

**SEC Filings (Public Companies Only)**

10-K. Provides detailed information on a company’s annual operations, business conditions, competitors, market conditions, legal proceedings, risk factors in holding the stock, and other, related information.  
10-Q. Updates investors about the company’s operations each quarter.  
S-1. Filed when a company wants to register new stock. Can contain information about the company’s operating history and business risks.  
S-2. Filed when a company is completing a material transaction, such as a merger or acquisition. Provides substantial detail underlying the terms and conditions of the transaction, the events surrounding the transaction, and justification for the merger or acquisition.  
8-K. Filed when a company faces a “material event,” such as a merger.  
Schedule 14A. A proxy statement. Gives details about the annual meeting and biographies of company officials and directors including stock ownership and pay.

**Websites**

- [www.bizbuysell.com](http://www.bizbuysell.com)  
- [www.capitaliq.com](http://www.capitaliq.com)  
- [www.dialog.com](http://www.dialog.com)  
- [www.edgar-online.com](http://www.edgar-online.com)  
- [http://edgarscan.pwglobal.com/serviets.edgarscan](http://edgarscan.pwglobal.com/serviets.edgarscan)  
- [www.factset.com](http://www.factset.com)  
- [http://finance.yahoo.com](http://finance.yahoo.com)  
- [www.freedgar.com](http://www.freedgar.com)  
- [www.hooversonline.com](http://www.hooversonline.com)  
- [www.lexisnexis.com](http://www.lexisnexis.com)  
- [www.mergernetwork.com](http://www.mergernetwork.com)  
- [www.mergers.net](http://www.mergers.net)  
- [www.onesource.com](http://www.onesource.com)  
- [www.quicken.com](http://www.quicken.com)  
- [www.sec.gov](http://www.sec.gov)  
- [www.washingtonresearchers.com](http://www.washingtonresearchers.com)  
- [www.worldm-anetwork.com](http://www.worldm-anetwork.com)

**Organizations**

- Value Line Investment Survey: Information on public companies  
- Directory of Corporate Affiliations: Corporate affiliations  
- Lexis/Nexis: Database of general business and legal information  
- Thomas Register: Organizes firms by products and services  
- Frost & Sullivan: Industry research  
- Findex.com: Financial information  
- Competitive Intelligence Professionals: Information about industries
process, they are identifying potential targets, doing valuation, and performing due
diligence on their own. This reflects efforts to save on investment banking fees, which can
easily be more than $5 million plus expenses on a $500 million transaction.4

PHASE 4: THE SCREENING PROCESS

The screening process is a refinement of the initial search process. It begins by pruning
the initial list of potential candidates created using the primary criteria discussed earlier.
Because relatively few primary criteria are used, the initial list may be lengthy. It can be
shortened using secondary selection criteria, but care should be taken to limit the number
of these criteria. An excessively long list of selection criteria will severely limit the number
of candidates that pass the screening process. The following selection criteria should be
quantified whenever possible.

Market Segment: A lengthy list of candidates can be shortened by identifying a target
segment within the industry. For example, a steel fabricated products company may
decide to diversify into the aluminum fabricated products industry. Whereas the
primary search criterion might have been firms in the aluminum flat-rolled products
industry, a secondary criterion could stipulate a segmenting of the market to identify
only those companies that make aluminum tubular products.

4Actual fee formulas are most often based on the purchase price. The so-called Lehman formula was at one
time a commonly used fee structure; in it, broker or finder fees would be equal to 5% of the first $1 million of
the purchase price, 4% of the second, 3% of the third, 2% of the fourth, and 1% of the remainder. Today, this
formula is often ignored in favor of a negotiated fee structure consisting of a basic fee (or retainer) paid
regardless of whether the deal is consummated, an additional closing fee paid on closing, and an
“extraordinary” fee paid under unusual circumstances that may delay the eventual closing, such as gaining
antitrust approval or achieving a hostile takeover. Fees vary widely, but 1% of the total purchase price plus
reimbursement of expenses is often considered reasonable. For small deals, the Lehman formula may apply.
Product Line: The product line criterion identifies a specific product line within the target market segment. The same steel fabrication firm may decide to focus its search on companies manufacturing aluminum tubular products used for lawn and patio furniture. Profitability: Profitability should be defined in terms of the percentage return on sales, assets, or total investment. This allows a more accurate comparison among candidates of different sizes. A firm with operating earnings of $5 million on sales of $100 million may be less attractive than a firm with $3 million in operating income on sales of $50 million because the latter firm may be more efficient.

Degree of Leverage: Debt-to-equity or debt-to-total capital ratios are used to measure the level of leverage or indebtedness. The acquiring company may not want to purchase a firm whose debt burden may cause the combined company’s leverage ratios to jeopardize its credit rating.

Market Share: The acquiring firm may be interested only in firms that are number 1 or 2 in market share in the targeted industry or in firms whose market share is some multiple (e.g., $2 \times$ the next-largest competitor). Cultural Compatibility: Insights into a firm’s corporate culture can be obtained from public statements about the target’s vision for the future and its governance practices as well as its reputation as a responsible corporate citizen. Examining employee demographics reveals much about the diversity of a firm’s workforce. Finally, an acquirer needs to determine whether it can adapt to the challenges of dealing with foreign firms such as different languages and customs.

PHASE 5: FIRST CONTACT

Using both the primary and secondary selection criteria makes it possible to bring the search to a close and to begin the next part of the acquisition planning process, first contact. For each target firm, it is necessary to develop an approach strategy in which the potential acquirer develops a profile of each firm to be contacted in order to be able to outline the reasons the target firm should consider an acquisition proposal. Such reasons could include the need for capital, a desire by the owner to “cash out,” and succession planning issues.

Research efforts should extend beyond publicly available information and include interviews with customers, suppliers, ex-employees, and trade associations in an effort to understand better the strengths, weaknesses, and objectives of potential target firms. Insights into management, ownership, performance, and business plans help provide a compelling rationale for the proposed acquisition and heighten the prospect of obtaining the target firm’s interest.

5 Firms that have substantially greater market share than their competitors often are able to achieve lower cost positions than their competitors because of economies of scale and experience curve effects.

6 America Online’s 2001 acquisition of Time Warner highlighted how difficult it can be to integrate a young, heterogeneous employee population with a much older, more homogeneous group. Also, as a much newer firm, AOL had a much less structured management style than was found in Time Warner’s more staid environment.
How initial contact is made depends on the size of the company, whether the potential acquirer has direct contacts with the target, whether the target is publicly or privately held, and the acquirer’s time frame for completing a transaction. The last factor can be extremely important. If time permits, there is no substitute for developing a personal relationship with the sellers—especially if theirs is a privately held firm. Developing a rapport often makes it possible to acquire a company that is not thought to be for sale. Personal relationships must be formed only at the highest levels within a privately held target firm. Founders or their heirs often have a strong paternalistic view of their businesses, whether they are large or small. Such firms often have great flexibility in negotiating a deal that “feels right” rather than simply holding out for the highest possible price. In contrast, personal relationships can go only so far when negotiating with a public company that has a fiduciary responsibility to its shareholders to get the best price. If time is a critical factor, acquirers may not have the luxury of developing personal relationships with the seller. Under these circumstances, a more expeditious approach must be taken.

For small companies with which the buyer has no direct contacts, it may only be necessary to initiate contact through a vaguely worded letter expressing interest in a joint venture or marketing alliance. During the follow-up telephone call, be prepared to discuss a range of options with the seller. Preparation before the first telephone contact is essential. If possible, script your comments. Get to the point quickly but indirectly. Identify yourself, your company, and its strengths. Demonstrate your understanding of the contact’s business and how an informal partnership could make sense. Be able to explain the benefits of your proposal to the contact—quickly and succinctly. If the opportunity arises, propose a range of options, including an acquisition. Listen carefully to the contact’s reaction. If the contact is willing to entertain the notion of an acquisition, request a face-to-face meeting.7

Whenever possible, use a trusted intermediary to make contact, generally at the highest level possible in the target firm. In some instances, the appropriate contact is the most senior manager, but it could be a disaffected large shareholder. Intermediaries include members of the acquirer’s board of directors or the firm’s outside legal counsel, accounting firm, lender, broker/finder, or investment banker. Intermediaries can be less intimidating than if you take a direct approach. When firms have a common board member, empirical research suggests that the likelihood of a deal closing is greater and the duration of the negotiation is usually shorter.8 Why? Direct or common connections enable both parties to gather information about the other party more easily which tends to promote trust. However, a high degree of familiarity between board members and senior management of the acquirer and target firms can lower announcement date acquirer financial returns if it causes cronyism resulting in less objective analysis and flawed decision making. There is evidence that in the presence of significant social ties there is a greater

7To ensure confidentiality, choose a meeting place that provides sufficient privacy. Create a written agenda for the meeting after soliciting input from all participants. The meeting should start with a review of your company and your perspective on the outlook for the industry. Encourage the potential target firm to provide information on its own operations and its outlook for the industry. Look for areas of consensus. After the meeting, send an e-mail to the other party highlighting what you believe was accomplished, and then await their feedback.

8Renneboog & Zhao, 2013.
likelihood that the target’s CEO and a larger fraction of the target’s preacquisition board will remain on the board of the combined firms after the merger.

For public companies, making contact at the highest level possible is extremely important. Discretion is critical because of the target’s concern about being “put into play”—that is, circumstances suggest that it may be an attractive investment opportunity for other firms. Even rumors of an acquisition can have adverse consequences for the target, as customers and suppliers express concern about a change of ownership and key employees leave concerned about an uncertain future. Such a change could imply variation in product or service quality, reliability, and the level of service provided under product warranty or maintenance contracts. Suppliers worry about possible disruptions in their production schedules as the transition to the new owner takes place. Employees worry about possible layoffs or changes in compensation. Shareholders may experience a dizzying ride as arbitrageurs, buying on the rumor, bid up the price of the stock, only to bail out if denial of the rumor appears credible.

**Discussing Value**

Neither the buyer nor the seller has any incentive to be the first to provide an estimate of value. It is difficult to back away from a number put on the table by either party should new information emerge. Getting a range may be the best you can do. Discussing values for recent acquisitions of similar businesses is one way to get a range. Another is to agree to a formula for calculating the purchase price. The purchase price may be defined in terms of a price to current year operating earnings’ multiple, enabling both parties to perform due diligence to reach a consensus on the actual current year’s earnings for the target firm. The firm’s current year’s earnings are then multiplied by the previously agreed-on price-to-earnings multiple to estimate the purchase price.

**Preliminary Legal Transaction Documents**

Typically, parties to M&A transactions negotiate a confidentiality agreement, a term sheet, and a letter of intent (LOI) early in the process. These are explained next.

**Confidentiality Agreement**

All parties to the deal usually want a confidentiality agreement (also called a nondisclosure agreement), which is generally mutually binding—that is, it covers all parties to the transaction. In negotiating the agreement, the buyer requests as much audited historical data and supplemental information as the seller is willing to provide. The prudent seller requests similar information about the buyer to assess the buyer’s financial credibility. The seller should determine the buyer’s credibility as soon as possible so as not to waste time

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10. Competitors will do what they can to fan these concerns in an effort to persuade current customers to switch and potential customers to defer buying decisions; key employees will be encouraged to defect to the competition.
with a potential buyer incapable of raising the financing to complete the transaction. The agreement should cover only information that is not publicly available and should have a reasonable expiration date.\textsuperscript{11}

**Term Sheet**

A term sheet outlines the primary areas of agreement and is often used as the basis for a more detailed LOI. A standard term sheet is typically two to four pages long and stipulates the total consideration or purchase price (often as a range), what is being acquired (i.e., assets or stock), limitations on the use of proprietary data, a no-shop provision that prevents the seller from sharing the terms of the buyer’s proposal with other potential buyers with the hope of instigating an auction environment, and a termination date. Many transactions skip the term sheet and go directly to negotiating an LOI.

**Letter of Intent**

Unlike the confidentiality agreement, not all parties to the deal may want an LOI. While the LOI can be useful in identifying areas of agreement and disagreement early in the process, the rights of all parties to the transaction, and certain protective provisions, it may delay the signing of a definitive purchase agreement and may also result in some legal risk to either the buyer or the seller if the deal is not consummated. Public companies that sign an LOI for a transaction that is likely to have a “material” impact on the buyer or seller may need to announce the LOI publicly to comply with securities law.

The LOI formally stipulates the reason for the agreement and major terms and conditions. It also indicates the responsibilities of both parties while the agreement is in force, a reasonable expiration date, and how all fees associated with the transaction will be paid. Major terms and conditions include a brief outline of the deal structure such as the payment of cash or stock for certain assets and the assumption of certain target company liabilities. The letter may also specify certain conditions such as an agreement that selected personnel of the target will not compete with the combined companies for some period should they leave. Another condition may indicate that a certain portion of the purchase price will be allocated to the noncompete agreement.\textsuperscript{12} The LOI also may place a portion of the purchase price in escrow, that is, held by a third party. The proposed purchase price may be expressed as a specific dollar figure, as a range, or as a multiple of some measure of value, such as operating earnings or cash flow. The LOI also specifies the types of data to be exchanged and the duration and extent of the initial due diligence. The LOI will terminate if the buyer and the seller do not reach agreement by a certain date. Legal, consulting, and asset transfer fees (i.e., payments made to governmental entities when ownership changes hands) may be paid for by the buyer or the seller, or they may be shared.

A well-written LOI usually contains language limiting the extent to which the agreement binds the two parties. Price or other provisions are generally subject to closing conditions, such as the buyers having full access to all of the seller’s books and records; having

\textsuperscript{11}The confidentiality agreement can be negotiated independently or as part of the term sheet or letter of intent.

\textsuperscript{12}Such an allocation of the purchase price is in the interests of the buyer because the amount of the allocation can be amortized over the life of the agreement. As such, it can be taken as a tax-deductible expense. However, it may constitute taxable income for the seller.
completed due diligence; having obtained financing; and having received approval from boards of directors, stockholders, and regulatory bodies. Other standard conditions include requiring signed employment contracts for key target firm executives and the completion of all necessary M&A documents. Failure to satisfy any of these conditions will invalidate the agreement. The LOI should also describe the due diligence process in some detail, stipulating how the buyer should access the seller’s premises, the frequency and duration of such access, and how intrusive such activities should be.

**PHASE 6: NEGOTIATION**

The negotiation phase often is the most complex aspect of the acquisition process. It is during this phase that the actual purchase price paid for the acquired business is determined, and often it will be quite different from the initial valuation of the target company. In this section, the emphasis is on negotiation in the context of problem solving or interest-based bargaining, in which parties look at their underlying interests rather than simply stating positions and making demands. In most successful negotiations, parties to the transaction search jointly for solutions to problems. All parties must be willing to make concessions that satisfy their own needs as well as the highest priority needs of the others involved in the negotiation.

The negotiation phase consists of four iterative activities that may begin at different times but tend to overlap (Figure 5.1). Due diligence starts as soon as the target is willing to allow it and, if permitted, runs throughout the negotiation process. Another activity is refining the preliminary valuation based on new data uncovered as part of due diligence, enabling the buyer to understand the target’s value better. A third activity is deal structuring, which involves meeting the most important needs of both parties by addressing issues of risk and reward. The final activity, the financing plan, provides a reality check for the buyer by defining the maximum amount the buyer can expect to finance and, in turn, pay for the target company. These activities are detailed next.

**Refining Valuation**

The starting point for negotiation is to update the preliminary target company valuation based on new information. A buyer usually requests at least 3–5 years of historical financial data. While it is desirable to examine data audited in accordance with Generally Accepted Accounting Principles, such data may not be available for small, privately owned companies. Moreover, startup firms are unlikely to have any significant historical data as well.

The historical data should be normalized, or adjusted for nonrecurring gains, losses, or expenses.\(^{13}\) Such adjustments allow the buyer to smooth out irregularities to understand the dynamics of the business. Each major expense category should be expressed as a percentage of revenue. By observing year-to-year changes in these ratios, trends in the data are more discernible.

\(^{13}\)Nonrecurring gains or losses can result from the sale of land, equipment, product lines, patents, software, or copyrights. Nonrecurring expenses include severance payments, employee signing bonuses, and settlements of litigation.
Deal Structuring

Deal structuring is the process of identifying and satisfying as many of the highest priority objectives of the parties involved in the transaction as possible. The process begins with each party determining its own initial negotiating position, potential risks, options for managing risk, risk tolerance, and conditions under which either party will “walk away” from the negotiations. Deal structuring also entails understanding potential sources of disagreement—from simple arguments over basic facts to substantially more complex issues, such as the form of payment and legal, accounting, and tax structures. It also requires identifying conflicts of interest that can influence the outcome of discussions. For example, when a portion of the purchase price depends on the long-term performance of the acquired business, its management—often the former owner—may not behave in a manner that serves the acquirer’s best interests.

Decisions made throughout the deal-structuring process influence various attributes of the deal, including how ownership is determined, how assets are transferred, how ownership is protected (i.e., governance), and how risk is apportioned among parties to the transaction. Other attributes include the type, number, and complexity of the documents required for closing; the types of approvals required; and the time needed to complete the transaction. These decisions will influence how the combined companies will be managed, the amount and timing of resources committed, and the magnitude and timing of current and future tax liabilities.

The deal-structuring process can be viewed as comprising a number of interdependent components, including the acquisition vehicle, postclosing organization, legal form of the selling entity, form of payment, form of acquisition, and tax and accounting considerations. The acquisition vehicle refers to the legal structure (e.g., corporation or partnership) used to acquire the target company. The postclosing organization is the organizational and legal
framework (e.g., corporation or partnership) used to manage the combined businesses following the completion of the transaction. The legal form of the selling entity refers to whether the seller is a C or Subchapter S Corporation, a limited liability company, or a partnership.

The form of payment may consist of cash, common stock, debt, or some combination. Some portion of the payment may be deferred or be dependent on the future performance of the acquired entity. The form of acquisition reflects what is being acquired (e.g., stock or assets) and how ownership is being transferred. As a general rule, a transaction is taxable if remuneration paid to the target company’s shareholders is primarily something other than the acquirer’s stock, and it is nontaxable (i.e., tax deferred) if what they receive is largely acquirer stock. Finally, accounting considerations refer to the potential impact of financial reporting requirements on the earnings volatility of business combinations, due to the need to revalue acquired assets periodically to their fair market value as new information becomes available. Fair market value is what a willing buyer and seller, having access to the same information, would pay for an asset.\(^{14}\)

### Conducting Due Diligence

Due diligence is an exhaustive review of records and facilities and typically continues throughout the negotiation phase. Although some degree of protection is achieved through a well-written contract, legal documents should never be viewed as a substitute for conducting formal due diligence. Remedies for violating contract representations and warranties often require litigation, with the outcome uncertain. Due diligence may help to avoid the need for costly litigation by enabling the acquirer to identify and value target liabilities and to adjust the purchase price paid at closing accordingly. As such, reliance on contract remedies to recover M&A-related costs may be reduced because the incidence of surprises is likely to be less.\(^{15}\)

The failure to do an exhaustive due diligence can be disastrous. Technology giant, Hewlett-Packard, claimed in 2012 that it had been duped into overpaying for its 2011 acquisition of UK software maker Autonomy in October 2011. HP wrote-off $5 billion of the $11.1 billion it had paid for the firm alleging the seller engaged in “outright misrepresentations” in the agreement of purchase and sale signed by the two parties.

Table 5.1 lists convenient online sources of information that are helpful in conducting due diligence.\(^{16}\) While due diligence is most often associated with buyers, both sellers and lenders will also conduct due diligence.\(^{17}\)

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\(^{14}\)Changes in the value of assets and liabilities can result in one-time gains or losses recorded on the income statement thereby contributing to swings in earnings. For a more detailed discussion of how to structure M&A transactions, see DePamphilis (2010b).

\(^{15}\)Even if the acquirer was to win its lawsuit, receiving remuneration for breach of contract may be impossible if the seller declares bankruptcy, disappears, or moves assets to offshore accounts.

\(^{16}\)A detailed preliminary acquirer due diligence question list is provided on the companion site to this book.

\(^{17}\)For a detailed discussion of the due diligence process and best practices, see Selim (2003).
An expensive and exhausting process, due diligence is highly intrusive, and it places considerable demands on managers’ time and attention. Frequently, the buyer wants as much time as possible, while the seller will want to limit the length and scope. Due diligence rarely works to the advantage of the seller because a long and detailed due diligence is likely to uncover items the buyer will use as a reason to lower the purchase price. Consequently, sellers may seek to terminate due diligence before the buyer feels it is appropriate. If the target firm succeeds in reducing the amount of information disclosed to the target firm, it can expect to be required to make more representations and warranties as to the accuracy of its claims and promises in the purchase and sale agreement.

**The Components of Due Diligence**

Three primary reviews comprise due diligence; they often occur concurrently. The *strategic and operational review* conducted by senior operations and marketing management asks questions that focus on the seller’s management team, operations, and sales and marketing strategies. Senior managers should confirm that the proposed deal indeed supports the realization of the firm’s business strategy. The *financial review*, directed by financial and accounting personnel, focuses on the quality, timeliness, and completeness of the seller’s financial statements. That is, CFOs generally agree that high-quality financial statements are those recorded in a consistent manner over time, are supported by actual
The financial review also confirms that the anticipated synergies are real and can be achieved within a reasonable time frame. A legal review, which is conducted by the buyer’s legal counsel, deals with corporate records, financial matters, management and employee issues, tangible and intangible assets of the seller, and material contracts and obligations of the seller such as litigation and claims. Due diligence requires the creation of comprehensive checklists (see website accompanying this book for such a checklist). The interview process provides invaluable sources of information. By asking the same questions of a number of key managers, the acquirer is able to validate the accuracy of its conclusions.

**Buyer, Seller, and Lender Due Diligence**

Buyers use due diligence to validate assumptions underlying their preliminary valuation and to uncover new sources of value and risk. Key objectives include identifying and confirming sources of value or synergy and mitigating real or potential liability by looking for fatal flaws that reduce value. From the perspective of the buyer’s attorney, the due diligence review represents an opportunity to learn about the target firm in order to allocate risk properly among the parties to the negotiation, to unearth issues that reduce the likelihood of closing, and to assist their client in drafting the reps and warranties for the acquisition agreement. Table 5.2 categorizes potential sources of value from synergy that may be uncovered or confirmed during due diligence and the impact these may have on operating performance.

Although the bulk of due diligence is performed by the buyer on the seller, the prudent seller should also perform due diligence on the buyer and on its own personnel and operations. By investigating the buyer, the seller can determine whether the buyer has the financial wherewithal to finance the purchase. As part of its internal due diligence, a seller often requires its managers to sign affidavits attesting (to the “best of their knowledge”) to the truthfulness of what is being represented in the contract that pertains to their areas of responsibility. In doing so, the seller hopes to mitigate liability stemming from inaccuracies in the seller’s representations and warranties made in the definitive agreement of purchase and sale.

If the acquirer is borrowing to buy a target firm, the lender(s) will want to perform their own due diligence independent of the buyer’s effort. Multiple lender investigations, often performed concurrently, can be quite burdensome to the target firm’s management and employees. Sellers should agree to these activities only if confident the transaction will be consummated.

**The Rise of the Virtual Data Room**

The proliferation of new technologies has impacted the way in which data is stored, accessed, and analyzed during the due diligence process. While smaller deals often still involve presentations and the exchange of data (sometimes indexed in boxes or filing cabinets) in conference rooms, more and more deals utilize the virtual data room or VDR. A VDR is an online site used for storage and distribution of documents during the due

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18 Dichey et al., 2013.
### TABLE 5.2 Identifying Potential Sources of Value

<table>
<thead>
<tr>
<th>Potential source of value</th>
<th>Examples</th>
<th>Potential impact</th>
</tr>
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<tbody>
<tr>
<td><strong>OPERATING SYNERGY</strong></td>
<td></td>
<td></td>
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<tr>
<td>• Eliminating functional overlap</td>
<td>• Reduce duplicate overhead positions</td>
<td>• Improved margins</td>
</tr>
<tr>
<td>• Productivity improvement</td>
<td>• Increased output per employee</td>
<td>• Same</td>
</tr>
<tr>
<td>• Purchasing discounts</td>
<td>• Volume discounts on raw material purchases</td>
<td>• Same</td>
</tr>
<tr>
<td>• Working capital management</td>
<td>• Reduced days in receivables due to improved collection of accounts receivable</td>
<td>• Improved return on total assets</td>
</tr>
<tr>
<td></td>
<td>• Fewer days in inventory due to improved inventory turns</td>
<td>• Same</td>
</tr>
<tr>
<td>• Facilities management</td>
<td>• Increased production in underutilized facilities</td>
<td>• Same</td>
</tr>
<tr>
<td>– Economies of scale</td>
<td>– Data centers, R&amp;D functions, call centers, and so on, support multiple product lines/operations</td>
<td>• Same</td>
</tr>
<tr>
<td>– Economies of scope</td>
<td>• Reducing the number of layers of management</td>
<td>• Reduced bureaucratic inertia</td>
</tr>
<tr>
<td>• Organizational realignment</td>
<td></td>
<td></td>
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<tr>
<td><strong>FINANCIAL SYNERGY</strong></td>
<td></td>
<td></td>
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<tr>
<td>• Increased borrowing capacity</td>
<td>• Target has little debt and many unencumbered assets</td>
<td>• Increased access to financing</td>
</tr>
<tr>
<td>• Increased leverage</td>
<td>• Access to lower cost source of funds</td>
<td>• Lower cost of capital</td>
</tr>
<tr>
<td><strong>MARKETING/PRODUCT SYNERGY</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Access to new distribution channels</td>
<td>• Increased sales opportunities</td>
<td>• Increased revenue</td>
</tr>
<tr>
<td>• Cross-selling opportunities</td>
<td>• Selling acquirer products to target customers and vice versa</td>
<td>• Same</td>
</tr>
<tr>
<td>• Research and development</td>
<td>• Cross-fertilization of ideas</td>
<td>• More innovation</td>
</tr>
<tr>
<td>• Product development</td>
<td>• Increased advertising budget</td>
<td>• Improved market share</td>
</tr>
<tr>
<td><strong>CONTROL</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Opportunity identification</td>
<td>• Acquirer identifies opportunities not seen by target’s management</td>
<td>• New growth opportunities</td>
</tr>
<tr>
<td>• More proactive management style</td>
<td>• More decisive decision making</td>
<td>• Improved financial returns</td>
</tr>
</tbody>
</table>
diligence process. The VDR provides a convenient means of editing, indexing, and disseminating documents in a secure and confidential environment at any time and from any location. In some instances, the VDR has become a means of conducting data and document exchange throughout the entire deal. The VDR also provides an excellent “audit trail” or means of determining which parties accessed what data and when.

Data security is the number one challenge in using VDRs. The participants in the deal process must make sure that the data is as secure when stored in the “cloud” as it might be when overseen by a firm’s internal information technology department. Once an outside organization such as a vendor providing the VDR site makes available data for viewing by others, complete data security cannot be assured.

Developing the Financing Plan

The last of the four negotiation phase activities is to develop the balance sheet, income, and cash flow statements for the combined firms. Unlike the financial projections of cash flow made to value the target, these statements should include the expected cost of financing the transaction. Developing the financing plan is a key input in determining the purchase price, because it places a limitation on the amount the buyer can offer the seller. The financing plan is appended to the acquirer’s business and acquisition plans and is used to obtain financing for the transaction (see Chapter 13). No matter the size of the transaction, lenders and investors will want to see a coherent analysis of why the proposed transaction is a good investment opportunity.

Defining the Purchase Price

The three commonly used definitions of purchase price are total consideration, total purchase price/enterprise value, and net purchase price. Each serves a different purpose.

**Total Consideration**

In the purchase agreement, the total consideration consists of cash (C), stock (S), new debt issues (ND), or some combination of all three paid to the seller’s shareholders. It is a term commonly used in legal documents to reflect the different types of remuneration received by target company shareholders. Note that the remuneration can include both financial and non-financial assets such as real estate. Nonfinancial compensation sometimes is referred to as payment in kind. The debt counted in the total consideration is what the target company shareholders receive as payment for their stock, along with any cash or acquiring company stock. Each component should be viewed in present value terms; therefore, the total consideration is itself expressed in present value terms (PV_{TC}). The present value of cash is its face value. The stock component of the total consideration is the present value (PV_{S}) of future dividends or net cash flows or the acquiring firm’s stock price per share times the number of shares to be exchanged for each outstanding share of the seller’s stock. New debt issued by the acquiring company as part of the compensation paid to shareholders can be expressed as the present value (PV_{ND}) of the cumulative interest payments plus principal discounted at some appropriate market rate of interest (see Chapter 7).
**Total Purchase Price/Enterprise Value**

The total purchase price (\(PV_{\text{TPP}}\)) or enterprise value of the target firm consists of the total consideration (\(PV_{\text{TC}}\)) plus the market value of the target firm’s debt (\(PV_{\text{AD}}\)) assumed by the acquiring company. The enterprise value is sometimes expressed as the total purchase price plus net debt. Net debt includes the market value of debt assumed by the acquirer less cash and marketable securities on the books of the target firm. The enterprise value of the firm often is quoted in the media as the purchase price because it is most visible to those who are not familiar with the details. It is important to analysts and shareholders alike, because it approximates the total investment made by the acquiring firm. It is an approximation because it does not necessarily measure liabilities the acquirer is assuming that are not visible on the target firm’s balance sheet. Nor does it reflect the potential for recovering a portion of the total consideration paid to target company shareholders by selling undervalued or redundant assets. These considerations are reflected in the net purchase price, discussed next.

**Net Purchase Price**

The net purchase price (\(PV_{\text{NPP}}\)) is the total purchase price plus other assumed target firm liabilities (\(PV_{\text{OAL}}\)) less the proceeds from the sale of discretionary or redundant target assets (\(PV_{\text{DA}}\)) on or off the balance sheet. \(PV_{\text{OAL}}\) are those assumed liabilities not fully reflected on the target firm’s balance sheet or in the estimation of the economic value of the target firm. The net purchase price is the most comprehensive measure of the actual price paid for the target firm. It includes all known cash obligations assumed by the acquirer as well as any portion of the purchase price that is recovered through the sale of assets. The various definitions of price can be summarized as follows:

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19 Total investment equals what the acquirer pays the shareholders plus assumed liabilities such as long-term debt.

20 If the target firm’s balance sheet reserves reflected accurately all known future obligations and there were no potential off-balance-sheet liabilities, there would be no need to adjust the purchase price for assumed liabilities other than for short- and long-term debts assumed by the acquiring company. Earnings would accurately reflect the impact of known liabilities. Operating cash flows, which reflect both earnings and changes in balance sheet items, would also accurately reflect future liabilities. Therefore, valuations based on a multiple of earnings, book value, or discounted cash flow would accurately reflect the value of the business. In practice, reserves are often inadequate to satisfy pending claims. Common examples include underfunded or underreserved employee pension and healthcare obligations and uncollectable receivables. To the extent that such factors represent a future use of cash, the present value of their future impact should be estimated.

21 *Discretionary assets* are assets not required to operate the target that can be sold to recover some portion of the purchase price. Such assets include land valued at its historical cost. Other examples include cash balances in excess of normal working capital needs and product lines or operating units considered nonstrategic by the buyer. The sale of discretionary assets is not considered in the calculation of the value of the target because economic value is determined by future operating cash flows before consideration is given to how the transaction will be financed.
Total consideration = $PV_{TC} = C + PV_{S} + PV_{ND}$
Total purchase price or enterprise value = $PV_{TPP} = PV_{TC} + PV_{AD}$
Net purchase price = $PV_{NPP} = PV_{TPP} + PV_{OAL} - PV_{DA}$
\[= (C + PV_{S} + PV_{ND} + PV_{AD}) + PV_{OAL} - PV_{DA}\]

Although the total consideration is most important to the target company’s shareholders as a measure of what they receive in exchange for their stock, the acquirer’s shareholders often focus on the total purchase price/enterprise value as the actual amount paid for the target’s equity plus the value of assumed debt. However, the total purchase price tends to ignore other adjustments that should be made to determine actual or pending “out-of-pocket” cash spent by the acquirer. The net purchase price reflects adjustments to the total purchase price and is a much better indicator of whether the acquirer overpaid for the target firm. The application of the various definitions of the purchase price is addressed in more detail in Chapter 9.

**PHASE 7: DEVELOPING THE INTEGRATION PLAN**

Part of the premerger integration planning process involves the preclosing due diligence activity. One responsibility of the due diligence team is to identify ways in which assets, processes, and other resources can be combined to realize cost savings, productivity improvements, or other perceived synergies. This information is also essential for refining the valuation process by enabling planners to understand better the necessary sequencing of events and the resulting pace at which the expected synergies may be realized.

**Contract-Related Issues**

Integration planning also involves addressing human resource, customer, and supplier issues that overlap the change of ownership. These are transitional issues to resolve as part of the purchase agreement, and it is critical that the seller’s responsibilities be negotiated before closing to make the actual transition as smooth as possible. Also, a cooperative effort is most likely made prior to closing. For example, the agreement may stipulate how target company employees will be paid and how their benefit claims will be processed.\(^{22}\)

\(^{22}\)Systems must be in place to ensure that employees of the acquired company continue to be paid without disruption. If the number of employees is small, this may be accommodated easily by loading the acquirer’s payroll computer system with the necessary salary and personal information before closing or by having a third-party payroll processor perform these services. For larger operations or where employees are dispersed geographically, the target’s employees may continue to be paid for a specific period using the target’s existing payroll system. As for benefits, employee healthcare or disability claims tend to escalate just before a transaction closes as employees, whether they leave or stay with the new firm, file more health and disability claims for longer periods after downsizing. The sharp increase in such expenses can pose an unexpected financial burden for the acquirer and should be addressed in the merger agreement. For example, all claims incurred within a specific number of days before closing but not submitted by employees until after closing will be reimbursed by the seller. Alternatively, such claims may be paid from an escrow account containing a portion of the purchase price.
A prudent buyer will want to include assurances in the purchase agreement to limit its postclosing risk. Most seller representations and warranties (i.e., claims or statements of fact) made to the buyer refer to the past and present condition of the seller’s business. They pertain to items such as the ownership of securities; real and intellectual property; current levels of receivables, inventory, and debt; and pending lawsuits, worker disability, customer warranty claims; and an assurance that the target’s accounting practices are in accordance with Generally Accepted Accounting Principles. Although “reps and warranties” apply primarily to the past and current state of the seller’s business, they do have ramifications for the future. If a seller claims there are no lawsuits pending and a lawsuit is filed shortly after closing, the buyer may seek to recover damages from the seller. The buyer also may insist that certain conditions be satisfied before closing can take place. Common closing conditions include employment contracts, agreements not to compete, financing, and regulatory and shareholder approval. Finally, the buyer will want to make the final closing contingent on receiving approval from the appropriate regulatory agencies and shareholders of both companies before any money changes hands.

**Earning Trust**

Decisions made before closing affect postclosing integration activity. Successfully integrating firms require getting employees in both firms to work to achieve common objectives. This comes about through building credibility and trust, not through superficial slogans and empty promises. Trust comes from cooperation, keeping commitments, and experiencing success.

**Choosing the Integration Manager and Other Critical Decisions**

The buyer should designate an integration manager who possesses excellent interpersonal and project management skills. During the integration phase, interpersonal skills are frequently more important than professional and technical skills. The buyer must also determine what is critical to continuing the acquired company’s success during the first 12–24 months after the closing. Critical activities include identifying key managers, vendors, and customers and determining what is needed to retain them as valued assets. Preclosing integration planning activities should also determine the operating norms or standards required for continued operation of the businesses: executive compensation, labor contracts, billing procedures, product delivery times, and quality metrics. Finally, there must be a communication plan for all stakeholders that can be implemented immediately following closing, see Chapter 6 for more details.

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23Benefits packages, employment contracts, and retention bonuses to keep key employees typically are negotiated before the closing. Contractual covenants and conditions also affect integration. Earnouts, which are payments made to the seller based on the acquired business’s achieving certain profit or revenue targets, can limit the buyer’s ability to integrate the target effectively into the acquirer’s operations.
PHASE 8: CLOSING

Closing entails obtaining all necessary shareholder, regulatory, and third-party consents (e.g., customer and vendor contracts) and also completing the definitive purchase agreement. These are discussed next.

Gaining the Necessary Approvals

The buyer’s legal counsel is responsible for ensuring that the transaction is in compliance with securities, antitrust, and state corporation laws. Great care must be exercised to ensure that all filings required by law have been made with the Federal Trade Commission and the Department of Justice. Finally, many deals require approval by the acquirer and target firm shareholders. See Chapter 11 for detail on when shareholder approval is required.

Assigning Customer and Vendor Contracts

In a purchase of assets, many customer and vendor contracts cannot be assigned to the buyer without receiving written approval from the other parties. While often a formality, both vendors and customers may attempt to negotiate more favorable terms. Licenses must be approved by the licensor, which can be a major impediment to a timely closing. A major software vendor demanded a substantial increase in royalty payments before agreeing to transfer the software license to the buyer. The vendor knew that the software was critical for the ongoing operation of the target company’s data center. From the buyer’s perspective, the exorbitant increase in the fee had an adverse impact on the economics of the transaction and nearly caused the deal to collapse.

Completing the Acquisition/Merger Agreement

The acquisition/merger or definitive agreement is the cornerstone of the closing documents. It indicates all of the rights and obligations of the parties both before and after the closing.

Deal Provisions

In an asset or stock purchase, this section of the agreement defines the consideration or form of payment, how it will be paid, and the specific assets or shares to be acquired. In a merger, this section of the agreement defines the number (or fraction) of acquirer shares to be exchanged for each target share in a share for share exchange.

Price

The purchase price or total consideration may be fixed at the time of closing, subject to future adjustment, or it may be contingent on future performance. In asset transactions, it is common to exclude cash on the target’s balance sheet from the transaction; the price
paid for noncurrent assets, such as plant and intangible assets, will be fixed, but the price for current assets will depend on their levels at closing following an audit.

**Allocation of Price**

The buyer often tries to allocate as much of the purchase price as possible to depreciable assets, such as fixed assets, customer lists, and noncompete agreements, enabling them to depreciate or amortize these upwardly revised assets and reduce future taxable income. However, such an allocation may constitute taxable income to the seller. Both parties should agree on how the purchase price should be allocated in an asset transaction before closing, eliminating the chance that conflicting positions will be taken for tax reporting purposes.

**Payment Mechanism**

Payment may be made at closing by wire transfer or cashier’s check, or the buyer may defer the payment of a portion of the purchase price by issuing a promissory note to the seller. The buyer may agree to put the unpaid portion of the purchase price in escrow or through a holdback allowance, thereby facilitating the settlement of claims that might be made in the future.\(^{24}\)

**Assumption of Liabilities**

The seller retains those liabilities not assumed by the buyer. In instances such as environmental liabilities, unpaid taxes, and inadequately funded pension obligations, the courts may go after the buyer and the seller. In contrast, the buyer assumes all known and unknown liabilities in a merger or share purchase.

**Representations and Warranties**

Reps and warranties are claims made as “statements of fact” by buyers and sellers. As currently used, the terms are virtually indistinguishable from one another. They serve three purposes: disclosure, termination rights, and indemnification rights.

*Disclosure:* Contract reps and warranties should provide for full disclosure of all information germane to the deal, typically covering the areas of greatest concern to both parties. These include financial statements, corporate organization and good standing, capitalization, absence of undisclosed liabilities, current litigation, contracts, title to assets, taxes and tax returns, no violation of laws or regulations, employee benefit plans, labor issues, and insurance coverage.

*Termination rights:* Reps and warranties serve to allocate risk by serving as a closing condition. At closing, representations such as those concerning the state of the business and financial affairs are again reviewed, such that they must still be accurate despite the lapse of time between the signing of the agreement and the actual closing. If there has been a material change in the target’s business or financial affairs between signing and closing, the bidder has the right to terminate the transaction.

\(^{24}\)The escrow account involves the buyer’s putting a portion of the purchase price in an account held by a third party, while the holdback allowance generally does not.
Indemnification rights: Often in transactions involving private firms, certain representations will extend beyond closing. As such, they serve as a basis for indemnification, that is, the buyers being compensated for costs incurred subsequent to closing. For example, a seller may represent that there are no lawsuits pending, which turns out to be untrue after closing when the buyer incurs significant costs to settle a legal dispute initiated before there was a change in control. Indemnification will be discussed in more detail later in this chapter.

Covenants

Covenants are agreements by the parties about actions they agree to take or refrain from taking between signing the definitive agreement and the closing. The seller may be required to continue conducting business in the usual and customary manner and to seek approval for all expenditures that may be considered out of the ordinary such as one-time dividend payments or sizeable increases in management compensation. In contrast to reps and warranties, covenants do not relate to a point in time (e.g., at signing or closing) but, rather, relate to future behavior between signing and closing. While they usually expire at closing, covenants sometimes survive closing. Typical examples include a buyer’s covenant to register stock that it is issuing to the seller and to complete the dissolution of the firm following closing in an asset sale.

Covenants may be either negative (restrictive) or positive (requirement to do something). Negative covenants restrict a party from taking certain actions such as the payment of dividends or the sale of an asset without the permission of the buyer between signing and closing. Positive covenants may require the seller to continue to operate its business in a way that is consistent with its past practices. Many purchase agreements include virtually the same language in both representations and covenants. For example, since the target’s balance sheet is calculated just prior to signing the agreement, the target represents that the balance sheet that was calculated on a specific date just prior to signing is essentially the same balance sheet on the closing date. Covenants using the same language would require that the target firm not take any action between these two dates that would result in a material change in the balance sheet such as the payment of a dividend or significant capital expenditure.

Closing Conditions

The satisfaction of negotiated conditions determines whether a party to the agreement must consummate the deal. Among the most important of the closing conditions is the so-called bring-down provision, requiring that representations made at the signing are still true as of the closing date. Other examples include obtaining all necessary legal opinions, the execution of other agreements (e.g., promissory notes), and the absence of any “material adverse change” in the condition of the target company. The effects of material adverse change clauses (MACs) in agreements of purchase and sale became very visible during the disruption in the financial markets in 2008. Many firms that had signed M&A contracts looked for a way out. The most common challenge in negotiating such clauses is defining what constitutes materiality—for example, is it a 20% reduction in earnings or sales? Because of the inherent ambiguity, the contract language is usually vague, and it is this
very ambiguity that has enabled so many acquirers to withdraw from contracts. Lenders, too, use these clauses to withdraw financing.

**Indemnification**

In effect, indemnification is the reimbursement of the other party for a loss incurred following closing for which they were not responsible. The definitive agreement requires the seller to indemnify or absolve the buyer of liability in the event of misrepresentations or breaches of warranties or covenants. Similarly, the buyer usually agrees to indemnify the seller. Both parties generally want to limit the period during which the indemnity clauses remain in force.\(^\text{25}\)

**Other Closing Documents**

In addition to resolving the issues just outlined, closing may be complicated by the number and complexity of other documents required to complete the transaction. In addition to the definitive agreement, the more important documents often include patents, licenses, royalty agreements, trade names, and trademarks; labor and employment agreements; leases; mortgages, loan agreements, and lines of credit; stock and bond commitments and details; and supplier and customer contracts. Other documents could include distributor and sales representative agreements; stock option and employee incentive programs; and health and other benefit plans (which must be in place at closing, to eliminate lapsed coverage).

Complete descriptions of all foreign patents, facilities, and investments; insurance policies, coverage, and claims pending; intermediary fee arrangements; litigation pending for and against each party; and environmental compliance issues resolved or on track to be resolved often are part of the closing documents. Furthermore, seller’s corporate minutes of the board of directors and any other significant committee information, as well as articles of incorporation, bylaws, stock certificates, and corporate seals, are part of the final documentation.\(^\text{26}\)

**Financing Contingencies**

Most well-written agreements of purchase and sale contain a financing contingency. The buyer is not subject to the terms of the contract if the buyer cannot obtain adequate funding to complete the transaction. Breakup fees can be particularly useful to ensure that the buyer will attempt as aggressively as possible to obtain financing. In some instances, the seller may require the buyer to put a nonrefundable deposit in escrow, to be forfeited if the buyer is unable to obtain financing to complete the transaction.\(^\text{27}\)

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\(^\text{25}\) At least one full year of operation and a full audit are necessary to identify claims. Some claims (e.g., environmental) extend beyond the survival period of the indemnity clause. Usually, neither party can submit claims to the other until some minimum threshold, expressed in terms of the number or dollar size of claims, has been exceeded. Firms also may purchase warranty and indemnity insurance, which provides compensation for losses arising from breach of warranties and indemnities given in the merger agreement.

\(^\text{26}\) Sherman, 2006.

\(^\text{27}\) Most deals involving privately owned firms do not involve breakup fees, termination fees, or liquidated damage provisions, because such sellers are viewed as highly motivated. In the event the seller refuses to sell the business once having signed an agreement to do so, the buyer has a breach of contract lawsuit that it can bring against the seller.
The postclosing integration activity is widely viewed as among the most important phases of the acquisition process. Postclosing integration is discussed in considerable detail in Chapter 6. What follows is a discussion of those activities required immediately following closing. Such activities generally fall into five categories, which are discussed in the following sections.

**Communication Plans**

Implementing an effective communication plan immediately after the closing is crucial for retaining employees of the acquired firm and maintaining or boosting morale and productivity. The plan should address employee, customer, and vendor concerns. The message always should be honest and consistent. Employees need to understand how their compensation, including benefits, might change under the new ownership. Employees may find a loss of specific benefits palatable if they are perceived as offset by improvements in other benefits or working conditions. Customers want reassurance that there will be no deterioration in product or service quality or delivery time during the transition from old to new ownership. Vendors also are very interested in understanding how the change in ownership will affect their sales to the new firm.

Whenever possible, communication is best done on a face-to-face basis. Senior officers of the acquiring company can be sent to address employee groups (on site, if possible). Senior officers also should contact key customers (preferably in person or at least by telephone) to provide the needed reassurances. Meeting, with complete candor, reasonable requests for information from employees, customers, and vendors immediately following closing will contribute greatly to the sense of trust among stakeholders that is necessary for the ultimate success of the acquisition.

**Employee Retention**

Retaining middle-level managers should be a top priority during this phase of the acquisition process. Frequently, senior managers of the target company that the buyer chooses to retain are asked to sign employment agreements as a condition of closing. Although senior managers provide overall direction for the firm, middle-level managers execute the day-to-day operations of the firm. Plans should be in place to minimize the loss of such people. Bonuses, stock options, and enhanced sales commission schedules are commonly put in place to keep such managers.

**Satisfying Cash Flow Requirements**

Conversations with middle-level managers following closing often reveal areas in which maintenance expenditures have been deferred. Receivables previously thought to be collectable may have to be written off. Production may be disrupted as employees of the acquired firm find it difficult to adapt to new practices introduced by the acquiring
company’s management or if inventory levels are inadequate to maintain desired customer delivery times. Finally, more customers than had been anticipated may be lost to competitors that use the change in ownership as an opportunity to woo them away with various types of incentives.

**Employing Best Practices**

An excellent way for the combined companies to realize potential synergies is to take advantage of the strengths of both companies by using the “best practices” of both. However, in some areas, neither company may be employing what its customers believe to be the best practices in the industry. Management should look beyond its own operations to adopt the practices of other companies in the same or other industries.

**Cultural Issues**

Corporate cultures reflect the set of beliefs and behaviors of the management and employees of a corporation. Some firms are very paternalistic, and others are very “bottom-line” oriented. Some empower employees, whereas others believe in highly centralized control. Some promote problem solving within a team environment; others encourage individual performance. Inevitably, different corporate cultures impede postacquisition integration efforts. The key to success is taking the time to explain to all of the new firm’s employees what behaviors are expected and why and to tell managers that they should “walk the talk.”

**PHASE 10: CONDUCTING A POSTCLOSING EVALUATION**

The primary reasons for conducting a postclosing evaluation of all acquisitions are to determine if the acquisition is meeting expectations, to undertake corrective actions if necessary, and to identify what was done well and what should be done better in future deals.

**Do Not Change Performance Benchmarks**

Once the acquisition appears to be operating normally, evaluate the actual performance to that projected in the acquisition plan. Success should be defined in terms of actual to planned performance. Too often, management simply ignores the performance targets in the acquisition plan and accepts less than plan performance to justify the acquisition. This may be appropriate if circumstances beyond the firm’s control cause a change in the operating environment such as a recession or a change in the regulatory environment.

**Ask the Difficult Questions**

The types of questions asked vary depending on the time elapsed since the closing. After 6 months, what has the buyer learned about the business? Were the original
Learn from Mistakes

It always pays to identify lessons learned from each transaction. This is often a neglected exercise and results in firms’ repeating the same mistakes. This occurs because those involved in the acquisition process may change from one deal to another. Highly acquisitive companies can benefit greatly by dedicating certain legal, human resource, marketing, financial, and business development resources to support acquisitions made throughout the company. Despite evidence that abnormal financial returns to frequent acquirers tend to decline on average, there is evidence that such firms learn from experience through repetitive deals, especially when the acquirer’s CEO remains the same and the successive deals are similar.

The acquisition process consists of 10 phases. The first phase defines the business plan. If an acquisition is believed necessary to implement the business strategy, an acquisition plan, developed during the second phase, defines the key objectives, available resources, and management preferences for completing an acquisition. The next phase consists of the search for appropriate acquisition candidates. The screening phase is a refinement of the search phase. How the potential acquirer initiates first contact depends on the urgency of

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28 The acquirer should use the financial projections in the acquisition plan as performance benchmarks against which the target’s future performance can be measured. These benchmarks may allow for continued operating losses during the first few years as the business reinvests to fuel future growth. The decision to exit the business should be based on whether the actual losses are consistent with the projected benchmarks.

29 Fuller et al. (2002) document that acquirers, completing at least five deals within a 3-year period, earn an average 1.7% cumulative abnormal return, but from the fifth deal on they earn only 0.52%. While this could reflect overconfidence, Atkas et al. (2009) argue that this is consistent with learning by doing because experienced acquirers are better able to assess expected synergies and are willing to pay more to complete deals.

30 Atkas et al., 2013.
completing a deal, target size, and access to highly placed contacts within the target firm. The negotiation phase consists of refining valuation, deal structuring, conducting due diligence, and developing a financing plan. Integration planning must be done before closing. The closing phase includes wading through all the necessary third-party consents and regulatory and shareholder approvals. The postclosing integration phase entails communicating effectively with all stakeholders, retaining key employees, and identifying and resolving immediate cash flow needs. While commonly overlooked, the postclosing evaluation is critical if a firm is to learn from past mistakes.

CHAPTER DISCUSSION QUESTIONS

5.1 Identify at least three criteria that might be used to select a manufacturing firm as a potential acquisition candidate. A financial services firm? A high-technology firm?
5.2 Identify alternative ways to make “first contact” with a potential acquisition target. Why is confidentiality important? Under what circumstances might a potential acquirer make its intentions public?
5.3 What are the differences between total consideration, total purchase price/enterprise value, and net purchase price? How are these different concepts used?
5.4 What is the purpose of the buyer’s and the seller’s performing due diligence?
5.5 Why is preclosing integration planning important?
5.6 In a rush to complete its purchase of health software producer HBO, McKesson did not perform adequate due diligence but, rather, relied on representations and warranties in the agreement of sale and purchase. Within 6 months following closing, McKesson announced that it would have to reduce revenue by $327 million and net income by $191.5 million for the preceding 3 fiscal years to correct for accounting irregularities. The company’s stock fell by 48%. If HBO’s financial statements had been declared to be in accordance with GAAP, would McKesson have been justified in believing that HBO’s revenue and profit figures were 100% accurate? Explain your answer.
5.7 Find a transaction currently in the news. Speculate as to what criteria the buyer may have employed to identify the target company as an attractive takeover candidate. Be specific.
5.8 Fresenius, a German manufacturer of dialysis equipment, acquired APP Pharmaceuticals for $4.6 billion. The deal includes an earnout, under which Fresenius would pay as much as $970 million if APP reaches certain future financial targets. What is the purpose of the earnout? How does it affect the buyer and the seller?
5.9 MACs are a means for the parties to the contract to determine who will bear the risk of adverse events between the signing of an agreement and the closing. MACs are frequently not stated in dollar terms. How might MACs affect the negotiating strategies of the parties to the agreement during the period between signing and closing?
5.10 Despite disturbing discoveries during due diligence, Mattel acquired The Learning Company (TLC), a leading developer of software for toys, in a stock-for-stock transaction valued at $3.5 billion. Mattel had determined that TLC receivables were
overstated, a $50 million licensing deal had been prematurely put on the balance sheet, and TLC brands were becoming outdated. TLC also had substantially exaggerated the amount of money put into research and development for new software products. Nevertheless, driven to become a big player in children’s software, Mattel closed on the transaction, aware that TLC cash flows were overstated. After restructuring charges associated with the acquisition, Mattel’s consolidated net loss was $82.4 million on sales of $5.5 billion. Mattel’s stock fell by more than 35% to end the year at about $14 per share. What could Mattel have done to protect its interests better?

Answers to these Chapter Discussion Questions are available in the Online Instructor’s Manual for instructors using this book.

END OF CHAPTER CASE STUDY: GOOGLE’S FORAY INTO “DEVICE MAKERS” IN ITS SEARCH FOR THE NEXT BIG THING

Case Study Objectives: To Illustrate

- The challenge of translating vision into strategy
- The challenge of moving beyond a firm’s legacy business.

As one of the most successful firms on the planet measured by most any metric, Google represents a firm at a cross roads. How does it grow beyond the extraordinary success it has achieved in its legacy search business? How does it find the “next big thing” that will drive its revenue and profits? Its actions in recent years provide an important glimpse into the challenges associated with a firm trying to find its future beyond its legacy as the premier search engine on the globe.

Google’s website describes its mission/vision as organizing the world’s information and making it universally accessible and useful. Central to the firm’s culture is the quality of the people they hire, “favoring ability over experience.” The firm strives to maintain an open culture in which “everyone is a hands-on contributor and feels comfortable sharing ideas and opinions.” Among its core beliefs are a focus on the user and the ability to do one thing “really, really well.” Google notes its core capability is to provide users the ability to search from any location at any time vast amounts of information and to retrieve only that which is relevant.

Google states unequivocally that it is a business that makes money by offering search technology to companies and from the sale of advertising displayed on its website and other websites across the web. It pledges to conduct its business in a legal and socially responsible manner to maintain the highest possible trust among its users that the information it collects will not be used to their detriment.

At Google “great just isn’t good enough.” Through innovation, the firm aims to “take things that work well and improve upon them in unexpected ways.” The customers for its products and services are consumers, businesses, and the Web (i.e., community of web designers and developers). For consumers, the company strives to make it as easy as possible to find the information they need and to get the things they need done. For business, Google provides tools to help businesses engage in all aspects of e-commerce from advertising to fulfillment. For the
Web, Google engages in a variety of projects to make it easier for developers and designers to contribute the improvement of the Web.

Founded in 1998, Google continues to grow at a torrid pace, largely driven by the shift of advertising and commerce from traditional media and brick and mortar retail outlets to the Internet. This is likely to continue well into the foreseeable future. Furthermore, the firm’s profitability continues to rank well above most other technology firms. However, reflecting the effects of increasing infrastructure costs and efforts to diversify its core business, the firm’s operating margins have declined for 5 consecutive years. Despite accelerated efforts in recent years to diversify its revenue base, about 95% of the firm’s total 2013 revenue of more than $56 billion came from advertising on its website and those of its network members in 2013. See Table 5.3 for a trend in key financial performance indicators since 2008.

In recent years, Google has accelerated the pace of diversification by moving from a largely software business into one offering both software and hardware. The diversification effort into hardware businesses began in earnest in 2011 with Google’s $12.5 billion acquisition of wireless handset manufacturer Motorola Mobility. In 2013, Google acquired four robotics companies with products ranging from robot arms and heads to walking androids. In mid-2014, it purchased Titan Aerospace, a maker of high altitude solar powered drones, in an effort to bring internet access more cost effectively than satellites to millions of people in largely inaccessible places. Such drones are capable of staying aloft for several years. That same year, Facebook acquired Ascenta, a British based maker of similar types of drones.

What all these transactions have in common is that they involve the gathering and analysis of data. But is that enough to create real and sustainable synergy? What the firm was trying to achieve with this seemingly disparate and random acquisitions was puzzling to many observers.

In 2013, Google’s CEO, Larry Page, known for his emphasis on making audacious investment and a pragmatic management style mused at a Google developer conference in mid-2013 about how “technology should do the hard work so people can do the things that make them the happiest in life.” He noted that “today we are still scratching the surface of what is possible.” Google’s role in this future seems to be to use its core skills as a technology innovator to make what seems impossible today possible tomorrow.

Implicit in what Page is saying is that he sees a future world in which all things are connected via the Internet and that Google can benefit by getting more people to use the Internet. In turn, Google’s stakeholders from shareholders to employees to communities benefit as the firm’s revenues grow with increased Internet traffic. Shareholders gain by increasing profits, employees by increased opportunities and challenges and communities from more jobs and tax revenue.

### Table 5.3 Google Revenue, Operating Profit, and Operating Margins

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<th>12/31/13</th>
<th>12/31/12</th>
<th>12/31/11</th>
<th>12/31/10</th>
<th>12/31/09</th>
<th>12/31/08</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue ($millions)</td>
<td>$50,125</td>
<td>$37,905</td>
<td>$29,321</td>
<td>$23,651</td>
<td>$21,796</td>
<td></td>
</tr>
<tr>
<td>Operating profit ($millions)</td>
<td>$12,760</td>
<td>$11,742</td>
<td>$10,381</td>
<td>$8,312</td>
<td>$6,632</td>
<td></td>
</tr>
<tr>
<td>Operating margin (%)</td>
<td>25.43%</td>
<td>30.9%</td>
<td>35.40%</td>
<td>35.14%</td>
<td>30.43%</td>
<td></td>
</tr>
</tbody>
</table>

Source: Various Google annual reports.
Therefore, Google’s business strategy is implicitly to seek ways to get more people to use the Internet more frequently and in more diverse ways. But does this strategy facilitate the realization of the firm’s stated mission: organizing the world’s information and making it universally accessible and useful?

Since so much of what Internet users do online generates revenue for the firm, consistent with its mission, Google wants to pursue ways to make the Internet easier to use, more accessible, and faster. From its original search product, the firm has tried to improve the quality of search results by returning only those most relevant to the search request. The objective of the Google Chrome product was to build speed and ease of use. Through its fiber program the firm rolled out in 2013 in Kansas City, customers can get free internet access at generally acceptable rates of speeds and for additional fees can access increasing rates of speed reaching speeds purported to be 100 times faster than broadband. With respect to wireless devices, Google purchased Motorola Mobility to drive the spread of its Android operating system through smartphones and tablets displaying the Google logo. While promoting increased safety and fuel economy, Google’s self-driving cars allow for constant internet usage during daily commutes as the vehicle’s sensors communicate with the network.

Larry Page wants the firm’s new products and services to be those that get more people to use them multiple times daily. An important criterion for selecting new products and services has been dubbed the “toothbrush test” (analogous to toothbrushes used at least twice daily). The firm’s search capability and Android operating system for wireless devices satisfy this criterion. Having penetrated the software market in a big way, the firm is now pushing into the hardware market with software embedded in such products as cars and glasses to robots and thermostats.

With its sight on enlarging its exposure in the hardware business, Google announced on January 13, 2014, that it would pay a whopping (almost 12 times annual revenue) $3.2 billion for Nest Labs, a manufacturer of thermostats and smoke detectors. The Nest deal takes Google into the home heating, air conditioning, and appliance business as a parts and services supplier. Nest is in the business of energy management, with reported annual revenues of $275 million. Utilities pay Nest $30 to $50 monthly to manage the energy usage of Nest customers who had opted into their utility’s demand-response programs. As part of the programs, Nest temporarily takes control of a home’s heating and cooling for a set period. Customers are notified that their home’s temperature is about to be changed in advance. When this is done over large neighborhoods, utility energy costs are lowered by as much as 50% by re-routing peak energy being used in empty homes. Consistent with past practices, Nest will be operated as a wholly owned independent subsidiary of Google.

Tony Fadell, Nest’s CEO, describes Google’s acquisition of his firm as its further penetration of the “Internet of Things.” This is a metaphor for a world in which many different types of devices connected wirelessly use a combination of software ad sensors to communicate with one another and their owners. Perhaps somewhat whimsically, given its largely amorphous definition, the “Internet of Things” has been described as having a potential size of $19 trillion, larger than the size of the US annual gross domestic product. The movement toward the “Internet of Things” is expected to accelerate in the relatively near future. Increasingly sophisticated interconnected devices ranging from smartphones and tablets to thermostats and smoke alarms that Nest makes to smartwatches and other wearable technologies increasingly penetrate every aspect of our lives.
Google is not alone in pursuing this vision of the future. Samsung announced a new smart-home computing platform that will let people control washing machines, televisions, and other devices it makes from a single app. Microsoft, the world’s biggest maker of software, is working to transform itself into a devices, software, and services firm. The acquisition of Nokia brings it an array of new devices that utilize a common wireless operating system.

Some argue that Google’s entry into hardware is at some level simply an imitation of Apple’s fabulously successful strategy. That is, create your own devices to sell software and services. Apple has demonstrated that properly designed devices win brand recognition followed by exploding sales and profit. Further, they establish an ongoing relationship between the firm and its customers within a so-called ecosystem of interconnected software and hardware products. Once established, the firm can sell additional products and content through these devices to its customers. The ecosystem currently includes a variety of mobile wireless devices that run apps, TV shows, movies, music and other content today and most likely the car, home appliances, and health services in the future.

The challenges for Google in making these hardware acquisitions are fourfold: logistical, public relations, cultural, and competitive. The logistics associated with promotion of cooperation between the new units and existing Google operations and the cross-fertilization of ideas could be daunting. Without these activities, it is unlikely that the firm can fully leverage its highly impressive technology infrastructure without being stifled by a burgeoning bureaucracy that has grown to 46,000 employees. Since the new businesses are operated largely as independent entities within Google, the usual methods for promoting the desired behaviors such as colocation and sharing of facilities are difficult making contact among current employees and those with the new units problematic.

Entry into the “Internet of Things” also poses serious privacy concerns among regulators and activists, potentially creating a public relations nightmare for Google. The increasing intrusion into personal lives and the accumulation of data on personal habits and lifestyles could trigger an explosive backlash against companies attempting to enlarge their positions in the “Internet of Things.” The backlash could take the form of customer boycotts of the firm’s products or calls for increased government regulation.

Google’s entry into hardware is a radical departure from past practices. Google has relied on partners, including Samsung, to promote its Android mobile operating system software and its apps ecosystem as a rival to Apple’s iPhone, iPad, and to its iOS software. This changed in 2011 with Google’s acquisition of Motorola Mobility. Motorola gives Google its own branded smartphone for promoting its Android system and for attracting customers to Google Play Store, a competitor to Apple’s iTunes and App Store. Google’s new acquisitions now put them squarely in competition with its traditional partners.

Finally, the addition of hardware businesses creates a cultural conflict in a firm whose employees were accustomed historically to developing and selling software services. The production and the sale of hardware will require a fundamental change in the mindset of those employees required to work with the new hardware business if hardware is to become an important platform for delivering software and content developed by other units within Google. For example, selling services is significantly different from selling hardware. Services can be more readily customized to satisfy a customer’s needs and once sold require less marketing and selling...
effort to maintain an ongoing relationship with the customer. In contrast, hardware products often become commodities with few if any meaningful distinguishing features often require an ongoing aggressive marketing and selling campaign to sustain and grow sales.

With Nest, Google puts its logo on another device. For the immediate future, Google will use Nest as a hub of products targeted at the residential home “Internet of Things.” Because Google makes most of its money selling advertising and collecting information about users and how they use the Internet, the penetration of the market for in-home energy products enables the firm to collect additional information about how people use products in their personal residences. The sensors and software in these in-home devices enable Google to tap into that data.

In early 2014, under pressure from investors and analysts, Google decided to cut its losses on its Motorola Mobility acquisition by announcing it had reached an agreement to sell the unit to Chinese PC maker, Lenovo, for $2.91 billion. Google retained the rights to the intellectual property that it had acquired in buying Motorola Mobility, while granting a license to Lenovo to use certain patents to produce its handsets.\textsuperscript{31} Despite three rounds of layoffs, Motorola Mobility lost more than $1 billion in operating income in 2013. While Motorola’s most recent offering Moto X in late 2013 has been well received, its sales have not been sufficient to stem hemorrhaging cash flow. It had become increasingly clear that continued investment in the unit was not likely to turnaround the business. Moreover, exiting the handset business would assuage concerns among major handset makers that were using Android to power their phones. They had expressed concern since Google acquired Motorola Mobility in 2011 that Google could become a competitor.

While history rarely repeats itself exactly in the same way, certain parallels may be drawn between Microsoft’s experience with diversification and what Google is currently doing. Microsoft once having achieved dominance in the global PC operating system market and for integrated apps such as Microsoft Office lost its way in trying to diversify into a plethora of largely unrelated businesses. Also, it was late to the mobile device revolution and has been playing catch up for years, most recently illustrated by its acquisition in 2014 of Nokia’s phone handset manufacturing business.

Google, which continues to dominate the global Internet search market, may be on the verge of diffusing its resources on only loosely related investments in its seemingly haphazard search for the “next big thing.” As has been the case with Microsoft, Google’s healthy cash flows will allow it to sustain its effort to diversity for a long period of time. Both Google and Microsoft are likely to continue no doubt to dominate their respective markets for many years to come, with Microsoft’s cash flows sustained by its huge installed base of users and Google’s cash flow by the continued shift of retail trade to the Internet. However, their sustained success will ultimately depend on their ability to foresee and implement the next great disruptive technology. As both firms continue to get ever larger and more bureaucratic, history shows that all too often such firms lack the nimbleness to maneuver effectively in a rapidly changing technology environment.

\textsuperscript{31}The actual loss on the sale is considerably less than that implied by the $12.5 billion paid for Motorola Mobility. When Google completed the deal, Google gained access to Motorola Mobility’s $3 billion in cash on hand and promptly sold Motorola’s set-top box business for $2.4 billion. So the actual loss on the sale depends on what valuation is put on the acquired patents.
Discussion Questions

1. A corporate vision can be described narrowly or broadly. Google’s website describes its mission/vision as organizing the world’s information and making it universally accessible and useful. What does this mission statement tell you about what Google believes its core competence is and what market needs it is targeting? How useful do you find this mission in setting Google’s strategy? (Hint: Discuss the advantages and disadvantages of a broad versus narrow vision statement for a corporation.) If you were the CEO of Google, what might your vision for its future be? Explain the rationale for your answer.

2. In the context of M&A, synergy represents the incremental cash flows generated by combining two businesses. Identify the potential synergies you believe could be realized in Google’s acquisition of Nest that could be achieved by leveraging other Google products and services. Be specific. Identify synergies Google is not likely to realize by operating the firm as a wholly owned largely autonomous subsidiary. Speculate as to why Google has chosen to operate Nest in this manner.

3. Describe Google’s investment strategy? What are the factors driving this strategy? How might shareholders eventually react to this strategy? How might this investment strategy hurt the firm long term?

4. Describe what you believe to be Google’s business strategy? Would you describe their strategy as cost leadership, differentiation, focus, or a hybrid strategy? Explain your answer. To what extent do you believe it is driven by changes in the firm’s external environment? To what extent have factors internal to the firm driven Google’s business strategy?

5. What are the potential threats to Google’s current vision and business strategy?

Solutions to these case study discussion questions are found in the Online Instructor’s Manual available to instructors using this book.

ADDITIONAL CASE STUDY RECOMMENDATIONS (SEARCH HARVARD BUSINESS SCHOOL PUBLISHING SITE BY NAME OF CASE: hbsp.harvard.edu)

Subjects Covered: Acquisition Target Selection, Conglomerates, Corporate Strategy, Diversification.

Subjects Covered: Government Intervention, Negotiation.

Subjects Covered: International Expansion, Bidding Process, Cultural

II. THE MERGERS AND ACQUISITIONS PROCESS
II. THE MERGERS AND ACQUISITIONS PROCESS