How to Cut a Deal When an M&A Looks D.O.A.

By John L. Coker

At 9:20 on Monday morning, the CFO of Genes23 Corp. takes a phone call. The voice on the other line says, "Hello, I'm Barbara Swenback of the London office of FinAd Partners. We have a client that seeks to be acquired—DiaCorp, in Dover, England. I'm sure you know them. Can we talk?"*

Swenback spent the next 20 minutes describing how DiaCorp has been successful as the world's second-largest provider of genetics tests to determine a person's predisposition to certain serious diseases, either from inheritance or gene mutation. She acknowledged that Genes23 is the largest player in the field.

Swenback concluded with a startling revelation: "Now I'll share a problem with you. We at FinAd Partners have been directed to seek interest from anyone *but* Genes23 Corp. I presume that the companies' past interactions have been more difficult than just energetically competitive, but I thought I'd call anyway."

**The author has changed the names of the people, companies, valuation amounts, and type of industry involved in this transaction.*

The CFO explained that the difficulties between Genes23 and DiaCorp occurred during the term of a previous Genes23 executive team, and the company is now enthusiastic to move on and learn more. He asked why DiaCorp is selling and what Genes23 can do to become a potential partner. Swenback responded that an in-person visit to DiaCorp's headquarters in Dover, England, to meet with the CEO, founder, and majority shareholder, Dr. Randolph Corvan, might be successful in breaking the ice and reversing the negative perceptions.

The CFO agreed to seek executive and board approval to take the next, very tentative step of a preliminary, exploratory meeting. Meanwhile, Swenback said she'd talk to Corvan to attempt to convince him to consider loosening DiaCorp's "no-Genes23" stance enough to entertain a meeting.

Forty-five minutes later, the CFO's phone rings again. "Swenback here. Can you be in Dover on Tuesday?"

Lesson Learned?
Create an Opportunity Proactively.

Genes23 needed an opportunity to bring a new dimension of strategic value to the company. With nearly 400 employees, this 16-year-old, $200 million firm had been growing rapidly until the past two years, during which there was only incremental improvement.

The company created the opportunity by:

◆ ***Answering the phone.*** Simple, right? But in this case, there would be an understandable tendency to go no further after hearing that FinAd Partners is a mergers and acquisitions (M&A) firm representing a long-standing, difficult, and deeply adversarial competitor.

◆ ***Avoiding a negative atmosphere.*** The CFO wasn't insulted when he heard that FinAd had been directed to steer clear of Genes23, nor did he argue, challenge, or counterattack DiaCorp's unusually negative, implicitly condescending position.

◆ ***Ignoring the competition.*** The CFO didn't ask about who else FinAd would be contacting or what responses had been elicited so far. Evidently, he knew that (1) he would be unlikely to get any meaningful response, (2) he would appear inexperienced for asking, and (3) even if he did receive such information he wouldn't use it to his advantage (as we'll discuss later).

As you can see, in an era where most people use texting or e-mail as their default modes of communication, the good, old-fashioned telephone can open the door to a rare business opportunity.

The Company Reacts

The CFO interrupted his busily e-mailing CEO with, "Pardon, Boss. My phone rang twice this morning, and I think I've got some exciting news for you." He described the phone calls from FinAd Partners and the barriers that would need to be torn down in order to pursue this opportunity.

Within a few days, the two executives had prepared an analysis outlining the important strategic reasons for taking the next step in putting the companies together:

Geographic Market Synergy.

Genes23 has a laboratory at its headquarters in Pasadena, Calif., and has the deepest market focus in North America. DiaCorp has a laboratory in Singapore and the top penetration in Asia. With DiaCorp's secondary lab in Dover, England, and Genes23's in Paris, France, the combined companies would be a major force in the field of diagnostics in Europe and throughout the developed world. They could improve sales significantly by offering each firm's proprietary products to the other's customers.

Laboratory Technology Synergy.

Each of the companies has developed proprietary processes that improve the accuracy of the genetic code analysis for certain disease-state tests. But few of these process improvements address the same testing specifics. Together, applying each company's proprietary technology to the other's tests, they could provide the diagnostics community with superior gene-based science and forecast the revenue improvements that would result from capturing customers from third-party competitors.

Next Steps

After working with the CFO to put the finishing touches on their analysis, Genes23's CEO called the company's nonexecutive chairman of the board, an investment banker in New York, and described the opportunity (albeit, with significant hurdles still to clear). The chairman scheduled a conference call with the board for the next day.

In the meeting, the CEO presented the executives' analysis of the geographic market and laboratory technology synergies. He concluded with several less-well-quantifiable yet potentially valuable perks of a successful M&A, including, for example, scientific cross-training of laboratory technicians and a reduction in sales-force travel as the teams are combined and geographic territories/assignments are assigned more tightly.

After the CEO's presentation, one banker board member asked against whom they would be bidding. The CEO replied, "We didn't ask. But you can take a random sample from the last World Diagnostics Conference attendee list and do as well as such a query could have done."

The board members chuckled in unison and approved the acquisition plans. The CEO leaned over to the CFO, who was in attendance *ex officio*, and said, "Tell FinAd we'll give it a go on Tuesday. You'll be our representative in Dover."

Lesson Learned? Create Value Strategically.

The Genes23 executives convinced the board to proceed by envisioning the value strategically—through geographic market penetration and proprietary technology interaction. Strategic value brings real value to the buyer's customers, to the seller's customers, and, therefore, to shareholders. Regardless of industry sector, strategic synergies allow for cross-sharing of skills, experiences, and information across all the active functions of both businesses, including, for example:

- ◆ Proprietary research data and findings,
- ◆ Customer survey results,
- ◆ Data regarding complaints, and
- ◆ Training facilities and capabilities.

Buyers commonly make the mistake of overlooking strategic synergies with nonquantifiable value in deciding whether or not to do a deal. While putting a price tag on these synergies is at best difficult and requires some imagination, recognizing and appreciating their existence and strategic importance adds a vital cornerstone to the foundation on which the decision to go forward depends. We shall soon see how Genes23 wove the value for the inherently nonquantifiable attractions into its evaluation.

Often, M&A decisions aren't founded in strategic improvement but in the irrational urge to keep the target out of the hands of the competition. If the players lack the strategic synergies of Genes23 and DiaCorp, the acquiring company could suffer negative financial and operational consequences. You've surely read about the occasional situation in which such a lack of synergy triggers the decision to send the acquired company back onto the market, often for a substantial discount to the original acquisition price. Firms with a clearly executed vision rarely let that happen.

Introduction in Dover

"Dr. Corvan," began Genes23's CFO, "I'm here in Dover to learn from you how Genes23 and DiaCorp can bring together the expertise, the science, and the geographies of our companies to improve the diagnosis of genetic predisposition for serious diseases around the world."

One week after the initial call from FinAd, the CFO spent two full days in Dover, looking in microscopes with the VP of Research, studying sales territory maps with the VP of Marketing, and discussing the challenges of retaining key employees with the director of Human Resources. He expressed enthusiasm and asked many questions. He encouraged DiaCorp's executives to discuss how a combination of the companies might improve their offerings to providers of medical services.

When the CFO returned to his office in Pasadena, the CEO welcomed him back and said, "Yesterday, Barbara Swenback from FinAd called to say that our bid for DiaCorp would be enthusiastically received and considered. Good job!"

Lesson Learned? Create Vision Integrally.

Genes23 overcame the seller's reluctance by fostering the vision of a new combined team that would be best prepared to create unequalled value in a key, evolving sector of medical diagnostics.

The CFO created that teamwork foundation by:

◆ ***Meeting in person***—bringing the cement of interpersonal connection to the bricks of an envisioned coalition;

◆ ***Being prepared***—developing in advance the knowledge to understand what he would be seeing in the microscope, on the customer locations maps, and in the employment history charts; and

◆ ***Accentuating the positive***—focusing on what the two companies could do together rather than on what they couldn't.

The CFO also wisely avoided attacking the competition. Instead, he created a vision of an integrated team by engaging directly with DiaCorp as if they were already a merged entity.

The Company Bids

Genes23's CEO addressed his executive team with, "Now, let's get down to business." The instructions from FinAd were clear: Any considered offer for DiaCorp would be for all cash at closing. Declarations as to the methods of operation, post-closing maintenance of personnel, performance payouts, and nonquantitative bid elements wouldn't be considered.

The Genes23 team agreed to base the bid on the net present value (NPV) of the incremental improvements in estimated future EBITDA (earnings before interest, taxes, depreciation, and amortization) of the strategically integrated, combined businesses over the estimated NPV of the EBITDA they had prepared for Genes23 standing alone.

The NPV discount rate applied to the future EBITDA improvement forecasts was set at a rate only modestly greater than the aggregate cost of incremental capital. The team determined to keep this rate low, offsetting much of the discount typically associated with risk of performance with the benefits of the nonquantifiable values.

In totality, the bid calculation was a creative "textbook" approach. The board approved it in a teleconference, and it was submitted to FinAd a day earlier than the deadline. Six days later, Barbara Swenback called the CEO with "Congratulations, you won!"

Lesson Learned? Create Victory Imaginatively. The Genes23 bid was victorious because it was created with all the imagination of what the two most successful companies in the field could do together—bring new opportunity to both customer bases, new science to both sets of laboratories, and a new profile for broader customer opportunities.

In all potential M&As, imaginatively created value may be found beyond the marketing geography and service science that Genes23 envisioned. Most obvious and common may be the value of one party's process patents in the manufacturing operations of the other. Another common value can often be found simply in brand name recognition—predictively improved sales of one company's generic product under the recognizable brand name of the other.

Predicting the identity and bid levels of the competition is both common and understandable, but the Genes23 team had the imagination to envision the negative results of attempting to do this. They knew that the most likely result would be either ensuring success by overbidding or seeking a bargain and bidding so little that they would lose a great opportunity. Genes23 also didn't get caught up in the game of anticipating how the stock market would react to the announcement of a deal as the basis for preparing its actual bid, an unimaginative approach that would be detrimental to their shareholders and the deal itself.

Facing a Regulatory Challenge

Genes23's corporate counsel closed his congratulations to the CEO with, "Remember, don't announce anything until we have all regulatory approvals for the deal in place."

Counsel for Genes23 and DiaCorp agreed to file for acquisition approval with the Antitrust Division of the U.S. Department of Justice (DOJ) and the U.K. Office of Fair Trading (OFT). The DOJ quickly responded that the purchase price of less than $1 billion put the deal beneath its current radar screen and waived review. The OFT, however, was still working through its review practices. It soon appeared to Genes23 counsel that the OFT considered the Genes23/DiaCorp deal to be an opportunity to practice and polish its regulatory process.

One week into its review, the OFT requested a meeting. Genes23's CFO flew to London, joined with U.K. counsel, and was greeted cordially by the five-member OFT panel. The OFT chairman opened the meeting by stating, "Our mission here at OFT focuses on considering if there are potential antitrust implications of mergers in which the aggregate U.K. market share of the combined companies is less than 40%, establishing that as the upper acceptable limit. We've calculated your deal at 68%."

The OFT agreed to hold off on issuing a *Denied* finding if Genes23 could provide any input that might change the evaluation.

The company responded swiftly with a two-pronged approach. In the first prong, it carefully dissected the 68% calculation and found many small, boutique genetic-testing firms throughout Europe were doing similar tests but weren't included in the denominator of the calculation. Their capacities were added to the market size measure.

In the second prong, Genes23 took the unusual but valuable step of working with the OFT to get it in independent communication with many of the largest international pharmaceutical companies within the Genes23 client base. The OFT then enlisted these companies to express in writing to the OFT that their laboratories were fully ready to perform such tests themselves, rather than outsourcing them, if Genes23 raised prices in a monopolistic manner. The testing demand of these companies

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was added to the market size measure as well.

Then the OFT called Genes23 to return for a meeting, announcing to the CFO and corporate counsel, "Welcome back. We're at 38% and won't deny the deal." Genes23's stock price closed that day at $27, after which the CEO announced the deal and talked about his high hopes for the new merged company. The stock opened the next morning at $42.

Lesson Learned? Create Acceptance Cooperatively. The company took what looked like a sure denial and turned it into an acceptance by teaming up with the OFT to understand its calculation process and particulars. In the end, it was a win-win for both parties as the experience enabled the OFT to improve its evaluation metrics and identification processes. (Note: The OFT has since closed, and the Competition and Markets Authority has taken over many of its responsibilities.)

These cooperative methods are similarly effective in other forums where it is at least valuable or even necessary to get approval or acceptance of the deal, specific or tacit, from shareholder groups, labor union chapters, joint venture partners, and regulatory authorities overseeing corporate aspects other than antitrust. They all tend to work to a more satisfactory conclusion through cooperation rather than through confrontation.

A predictable, alternative approach would have been to challenge the process and the particulars, highlighting the OFT's limited experience and to degrade its evaluation metrics and identification process. Certainly the company could have challenged the assumption that all deals that result in capturing more than 40% of a customer base would lead to monopolistic practices and pricing.

Genes23 ultimately succeeded by teaming up, cooperating, and learning, not by challenging, attacking, and lecturing.

A Surprise Phone Call

Two weeks after announcing and closing the deal with DiaCorp, Genes23's CEO got a phone call: "Hello, I'm George Sidsen, the CEO of ServeBio. Last month I presented to our board of directors a five-year strategic plan that depends to a significant degree on having a world-leading genetic diagnostics company. So we determined to acquire either Genes23 or DiaCorp. Congratulations—we can't believe you successfully eliminated one of our choices!

"My board is convinced of our need to make this happen," Sidsen continued. "Would your board consider an offer for your combined business of $70 per share?"

The CEO replied with a laugh, "Not considering such an offer would probably be against the law!" Sidsen then offered to make a presentation to the Genes23 board, but the CEO said he doubted that would be necessary.

The Genes23 special board meeting produced an approval for a special shareholders' meeting in less time than it took to set up the teleconference. Antitrust regulatory approval was investigated and determined to be unnecessary in this case because ServeBio wasn't in the business of genetic testing.

ServeBio teamed with Genes23 to:

1. ***Create the opportunity proactively.*** ServeBio conceived and launched the opportunity on its own initiation, seeking to present a deeply dimensioned biopharmaceutical services company to the healthcare community.

2. ***Create value strategically.*** ServeBio overcame the difficulty of loss of choice to maintain its long-range strategic plan for bringing unique value to its field.

3. ***Create vision integrally.*** ServeBio shared its strategic plan and vision with Genes23 to bring pharmaceutical solutions to patients who have inherited disease-triggering genes.

4. ***Create victory imaginatively.*** ServeBio convinced its board that the strategic solution was unblemished by the combination of Genes23 and DiaCorp.

5. ***Create acceptance cooperatively.*** At the outset, ServeBio stated its interest in reaching the ultimate decision makers—the Genes23 board of directors.

As you can see from what I've described in this article, both ServeBio and Genes23 Corp. embraced the creative lessons of M&A processes, and both succeeded tremendously. Without knowing what awaited them on the other end of the line, when their management team heard their phones ring, they answered them. Lesson learned? Make sure you always answer yours, too! **SF**

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