M&A
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A Practical Guide to Doing the Deal

Second Edition

JEFFREY C. HOOKE

WILEY
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When most people hear the term “mergers and acquisitions,” the impression that comes to mind is a merciless corporate raider, who acquires a weakened corporate behemoth, strips the business of its assets, and fires thousands of innocent workers in the relentless pursuit of profit. This caricature is the gist for Hollywood films, but it holds true for only a minute fraction of transactions. The vast majority of M&A deals are friendly combinations between companies in the same, or a very similar, business.

The arranging, financing, and documenting of these combinations is a large industry in and of itself—employing a sizeable number of people in many vocations. The industry’s attributes—and the process through which deals are conceived and closed—thus merit the close attention of a broad cross-section of individuals, such as:

- Investment bankers involved with mergers and acquisitions (M&A).
- Equity analysts at hedge funds, risk arbitrage, pension funds, commercial banks, endowments, insurance companies, mutual funds, and sovereign wealth funds, who invest in firms engaged in M&A.
- Private equity professionals at buyout funds, venture capital funds, and hedge funds, who routinely buy and sell companies.
- Corporate financial executives and business development professionals.
- Institutional loan officers working with M&A and buyout transactions.
- Business students at colleges and graduate business schools.
- Investor relations professionals at corporations and public relations firms.
- Business appraisers, including those at appraisal firms, accounting firms, and consultancies.
- Lawyers who work with corporate clients on M&A-related legal, financial, and tax matters.
- Independent public accounting firms that review M&A accounting.
- Government regulators at the Federal Trade Commission (FTC), Department of Justice, Internal Revenue Service (IRS), Securities and Exchange Commission (SEC), Federal Deposit and Insurance Corporation...
(FDIC), Public Accounting Oversight Board (PCAOB), Comptroller of the Currency, and Federal Reserve (and their international counterparts).

- Government elected officials who are interested in privatization or M&A related effects on economies.
- Bank trust and private wealth advisers.
- Sophisticated individual investors.
- Consultants that assist acquirers in the M&A due diligence process concerning the information technology, human resources, environmental records and nonfinancial facets of the seller.

**RECENT TRENDS**

During the 16 years since the first edition was published, M&A activity has skyrocketed—increasing by a factor of four times—and the M&A community has expanded accordingly. Accompanying this growth were important changes to the business, including the following:

- **Embracing of M&A by smaller firms.** Previously the province of large companies, M&A is increasingly a sought-after growth option for mid-market enterprises.
- **Private equity.** The amount of capital provided to the private equity industry for leveraged buyouts has increased exponentially. Private equity is a more significant player in the M&A business than it was during the first edition’s introduction.
- **International.** Like other facets of American business, M&A has gained international acceptance, particularly in the developed economies of Western Europe. In recent years, M&A activity in emerging markets, such as China and Brazil, has grown.
- **Natural resources.** To complement traditional exploration programs, natural resource companies have ramped up acquisitions as a means to gain additional reserves at a reasonable cost.
- **Expansion of the Internet.** The expanded use of the Internet has made the M&A process easier for buyers and sellers, and thus it has facilitated the rise in transactions.
- **Increase in computing power, coupled with a decline in its cost.** Information related to prospective deals, their pricing, and their financing structure can be sliced and diced in numerous ways. This allows industry participants to quickly size up likely scenarios.
- **Rise in activist investors.** After a long hiatus, activist investors are stimulating M&A activity among publicly traded companies, encouraging those considered “undervalued” to sell themselves or conduct spin-offs.
Publicly traded companies represent a small subset of the deal universe, but they tend to involve the larger, more publicized transactions.

**OVERVIEW OF THE CONTENTS**

The book starts with a bird’s-eye view. We begin with the state of the global M&A markets and the motivations behind most acquisitions. I then synthesize the 10 principal motivations into the three financial tactics that govern the preponderance of deals. These topics represent Chapters 1–4.

After this high-level review, the book covers the age-old question: How does a buyer find an acquisition from the thousands of possible targets? The book outlines the methodical search process of successful acquirers and ends the discussion with the key attributes of “good” versus “bad” deals. This material is covered in Chapters 5–9.

Once the buyer has identified a few acquisition candidates, it assesses their financial histories and future prospects (Chapters 10–12). Then, it must consider the appropriate price to offer the owners. Chapters 13–17 provide a brief synopsis of corporate valuation techniques, the subject of many books including one of my own: *Security Analysis and Business Valuation on Wall Street* (John Wiley & Sons, second edition, 2010). The standard techniques for industrial and service firms represent the limit for most valuation books, but here I also cover special challenges, like natural resource companies, money-losing enterprises, cyclical businesses, and emerging markets firms. The special cases are important; few acquisition targets are U.S.-based, “vanilla” companies with a smooth upward trend of revenue and profit—that is, the kind you see in most textbooks.

If the buyer and seller are “close” on the seller’s valuation, the buyer then has to gauge the impact of the prospective transaction on its balance sheet, income statement and future equity price. Chapter 18 reviews the basics of M&A financial accounting for the combined firms. From this initial financial analysis, the buyer completes a computer model of the transaction. As Chapter 18 explains, the model provides the basis through which other financial actors—lenders, equity investors, and rating agencies—assess the deal. If the seller accepts buyer securities or contingent consideration, it too will consider modeling the transaction. The book discusses debt and equity finance in Chapter 18.

Up through Chapter 18, I focus on the buyer’s strategy tactics, valuation, accounting, and finance concerns, essentially descending from (a) the “big picture” viewpoint to (b) the day-to-day task of the buyer’s deal analysis. Chapter 19 takes a diversion and it discusses the reasons why sellers
sell and why a sale is often preferable to an initial public offering (IPO). Chapter 20 then proceeds to cover, in a step-by-step fashion, the process by which a sizeable business is sold.

Chapters 21 reviews the key legal documents encompassed in the sale process, as well as the common legal structures. A proper legal structure can save the buyer or seller significant monies, and it can offer either party substantial protection from unforeseen problems.

Chapter 22 examines several transaction categories, such as hostile takeovers, demergers, and reverse mergers, which fall into the mainstream from time to time. Such transactions gain popularity only to recede into obscurity, as economic or regulatory conditions change.

**WHAT’S NEW IN THE SECOND EDITION**

The methodical process needed to produce a successful M&A deal has not changed fundamentally over the past 30 years. However, the transaction environment, valuation techniques, financial accounting, and legal structures have evolved over time. This second edition provides the necessary updates, additional insights, fresh examples, and current anecdotes. I have rewritten the majority of the book to provide a more concise treatment of M&A and to reflect my broader international experience. This edition takes advantage of the knowledge I have gained from closing more deals, conducting executive education, and lecturing on M&A around the world.

To facilitate the reader’s understanding of the subject matter, the book is divided into five parts.

- Part One: The Big Picture
- Part Two: Finding a Deal
- Part Three: Target Financial Analysis
- Part Four: Acquisition Valuation
- Part Five: Combination, the Sale Process, Tax and Legal Structures, and Special Situations


For convenience, the pronoun *he* has been used throughout this book to refer nonspecifically to capital markets participants. The material herein will be equally useful to both men and women who evaluate M&A transactions.
This book will help you consider corporate strategies, make optimal M&A transactions, close better private equity deals, obtain superior arbitrage investments, and assess relevant regulatory matters. *M&A: A Practical Guide to Doing the Deal* provides a practical, well-rounded view of the M&A business and enables you to make sound judgments and to confront M&A's many challenges.

**JEFFREY C. HOOKE**  
*Chevy Chase, Maryland*  
*August 2014*
PART One

The Big Picture
This chapter reviews the global merger and acquisition (M&A) market and traces its expansion. Transactions are segmented into several categories, with most deals being medium-sized, private transactions. There is no guarantee of success in acquisitions.

AN UPWARD TREND, INTERRUPTED BY BOOMS AND BUSTS

M&A activity over the past 20 years has shown a marked growth trend, interrupted by peaks and valleys related to financial booms and busts. Volume spiked during the Internet bubble (1998–1999) and the private equity boom (2006–2007), only to drop significantly and then recover. Announced deals in the United States in 2013 totaled $1.1 trillion in volume, encompassing over 15,000 transactions. Figure 1.1 shows the trend line.

As the figure shows, the M&A market is a cyclical business. Activity is tied to several variables:

- Stock market valuations
- Availability of debt financing
- Optimistic views on the economy

When equity values rise in the stock market, an acquirer can offer his inflated stock to a seller as currency for the transaction. Using high-priced stock in a deal makes the transaction’s mathematics more attractive for the buyer. Alternatively, if the seller doesn’t want the buyer’s stock, the buyer can complete an equity raise in the public (or private) markets, and provide the seller with the necessary cash. The end result is thus identical.
For buyers to complete deals that make sense for their shareholders, borrowed money usually is part of the financing package. M&A activity is thus dependent on lenders—such as banks, finance companies, and bond funds—being open for business and willing to sign-off on the aggressive assumptions that often drive transactions.

High-priced stock investors, liberal lenders, and motivated buyers are all reflective of positive views on the strength of the economy, and this optimism promotes deals. Once a recession hits and the psychology goes negative, transaction volume dries up.

**M&A ACTIVITY BY GEOGRAPHY**

The United States and Canada represent a large share of M&A activity, and this continued to be the case in 2013. Typically, transactions are aggregated by four geographies. See Table 1.1.

The United States and Canada have about 22 percent of global gross domestic product (GDP), but they account for almost double that percentage in deal volume. Emerging markets, which are defined as countries having annual GDP per capita of US$9,000 or less, make up about 35 percent
of global GDP, yet their percentage of deals is much lower. We discuss these disparities in the next chapter.

**DEAL CATEGORIES**

M&A is segmented into four broad categories:

1. Horizontal
2. Vertical
3. Strategic/Diversification/Conglomerate
4. Private Equity

A *horizontal deal* is when a company acquires (a) a competitor, (b) a firm doing the same business in a different geography, or (c) an enterprise engaged in a product line that is similar to that of the buyer. Recent horizontal mergers include: (a) El Paso/Kinder Morgan, two U.S. pipeline companies, $36 billion value; (b) Amgen (U.S.)/Onyx (U.S.), two drug firms, $10 billion; and (c) Valeant Pharmaceuticals (Canada)/Bausch & Lomb (U.S.), two health-care product firms, $9 billion. Horizontal is the most popular deal category because it presents the buyer with the fewest operating risks. The buyer knows the target’s product line, suppliers, and customers, and it can institute cost saving measures with little disruption to the seller’s operations. Furthermore, in the case where the seller is a direct competitor, the acquirer has the added benefit of potentially raising prices with minimal customer resistance. Perhaps three quarters of all M&A deals fit the horizontal category.

A *vertical transaction* occurs when a company buys a supplier, distributor, or customer. A coal-burning electric utility that acquires a coal miner is one illustration. Most industries have drifted away from vertical integration,
with exceptions being the big oil companies, like Exxon and Chevron. So, vertical deals tend to be quite rare. See Figure 1.2.

Strategic, diversification, and conglomerate transactions take place when the buyer is engaged in a field that is unrelated to the seller. Sometimes, the buyer believes it has a set of strengths that can propel the seller’s business (or vice versa), and the transaction is thus part of a grand strategy to boost the buyer’s future. At other times, the buyer seeks to redepoly capital from its core business into another primary line, rather than disposing of the cash by paying higher dividends or repurchasing stock. Berkshire Hathaway, the insurance conglomerate, completed one of its many diversification deals when it purchased railroad Burlington Northern for $34 billion in 2010.

Strategic, diversification, and conglomerate deals represent about 10 percent of M&A activity.

Private equity participates in M&A principally through the leveraged buyout (LBO). An LBO is a transaction whereby a private equity fund (or a similar investor group) acquires a company and uses borrowed money to meet most of the cost of the deal. The private equity fund does not guarantee the loans, so the lenders look solely to the acquired company for repayment. Because an LBO is not a combination of similar businesses, the opportunities for an LBO to cut duplicate costs are minimal, and the investors rely on

![Vertical Industry Diagram: U.S. Electric Power](image-url)
new management, new operating tactics, or a rising stock market to boost values.

Through the LBO, private equity funds control many large U.S. corporations, such as Hertz Rent-A-Car, Hilton Hotels, and Caesar’s Entertainment, and the funds have made substantial inroads into Western Europe. At the LBO peak in 2006, such debt-funded deals represented 30 percent of M&A activity, a figure that has since dropped to about 10 percent according to data generated by Capital IQ.

**LARGE VERSUS SMALL TRANSACTIONS**

Large transactions involving publicly traded companies garner most of the media attention, and they account for 60 percent of dollar volume, out of 30,000 to 40,000 global deals per year, based on my estimations and data services. Three quarters of transactions involve privately owned firms (or divisions of publicly traded companies) with annual revenue under US$100 million equivalent, and 97 percent of purchase prices are under US$100 million.¹ One big $10 billion deal, therefore, equals the value of two hundred $50 million deals.

**M&A: NO GUARANTEE OF SUCCESS**

Despite all the hullaballoo surrounding M&A, numerous studies over the years have proven that over half of acquisitions do not increase the buyer’s per share equity value. However, most buyer executives, investment bankers and other practitioners fail to take such studies seriously, and they think that their deal will beat the odds. Such action is a calculated risk, and it reflects the corporate view that M&A is often the fastest means of growth. Why spend years developing new products and cultivating new customers, when you can acquire both in a few months with an M&A transaction? For many corporate managers, this logic is compelling and the opportunity for a big score outweighs the risk.

M&A’s acceptance by United States’ operating companies and financial markets is facilitated by the government’s light regulatory hand. Most deals involve competitors or similar businesses, yet U.S. authorities rarely challenge transactions on antitrust grounds. Compared to other jurisdictions, legal protections for those U.S. workers displaced by M&A cost-cutting are minimal; and, thus, acquirers can realize cost synergies with little government interference. For large public deals, federal and state regulations allow the buyer’s stockholders a minor role. Management dominates the process even if the acquisition price appears overly generous and thus injurious to