Acquisition Process: The Gee Whiz Media Case Study

The Dream

Like most start-up companies, Gee Whiz Media (GWM) was the product of the visionary zeal of its founder Dan Durand. Dan had a longstanding reputation in the local technology community of being a gifted visionary who put a premium on honesty. In the industry, he was known for his integrity in his relationships with employees, customers, and suppliers. This reputation had come from several successful start-ups he had taken public in the 1980s. He found that this was a particularly good way to do business because those with whom he dealt generally were willing to accept his word at face value. This reputation was to serve him well in his next venture.

In the late 1980s, an emerging technology called multimedia caught Dan's imagination. CD-ROMs were one of the few media with the capacity to store such diverse types of information as sound, video, and text. As PCs became commonplace, Dan believed that CD-ROMs would revolutionize in-home entertainment by allowing users to interact easily with the new media. Dan convinced the owner of a local retail computer store to provide space for him to demonstrate the wonders of multimedia. He reasoned that if consumers saw that computers didn't need to be boring, they might buy a complete system including a CD-ROM drive, speakers, and graphics programs. Dan would get a percentage of the sale. Thus, GWM was born.

Building the Business Plan

Dan and his staff of nine met in his home to define their place in the evolving multimedia industry. Together, they attempted to summarize the competitive dynamics underlying the multimedia industry. Early pioneers in the industry viewed it as electronic publishing, the conversion of text, video, and music to an electronic medium. Major segments included entertainment (e.g., music videos), games, sports, education, hobbies, "how-to" or training manuals, and career development applications. Game applications proved to be a hit and demonstrated that there was demand for the right content. Reference CD-ROMs, Dan reasoned, might do even better because they were reusable and beautiful.

More and more small companies were entering the industry. Few resources were required other than the knowledge to develop the requisite software and the creativity to develop exciting content or the rights to use existing content. No one company as of yet dominated the industry, but Dan knew that it was just a matter of time. Although CD-ROMs held great promise, the risk was still great. CD-ROM drives were in less than 30% of personal computers. In the early 1990s, CD-ROM technology was still in its infancy. Video appeared very erratic rather than seamless like the big-screen movie. Durand saw CD-ROMs as modern encyclopedias, where information could be retrieved by a click of the mouse rather than by flipping pages. Moreover, instead of just text and pictures, a multimedia reference guide could have movies and music. Several days of brainstorming caused Dan and his staff to agree to focus on the music entertainment segment, because they saw it as large and growing and subject to less intense competition than the game segment. GWM proposed to apply multimedia technology to famous artists in the music industry.

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Dan's dream for GWM was to put a well-known artist on a CD-ROM and make it into a nationally recognized brand name. This, he thought, would move GWM from a narrow niche player into a national brand name in the CD-ROM business. It could be an Activision, a Broderbund, or maybe even a Microsoft. After some honest soul searching, Dan and his staff quickly realized that, although they did have an exciting vision and some highly talented technical people and artists on staff, they lacked access to proprietary content, advertising, and a distribution channel to get the CD-ROM to market.

Although they had decided on a niche, Dan knew that the challenges would be great. They did have significant brand recognition in this narrow market segment, because they were the first to target this market with a unique product on a relatively new medium, CD-ROMs. They also would benefit at least in the short run from the royalty arrangements they had with Apple and others, which would provide some cash-flow stability. Moreover, they were highly motivated by the prospect of dominating a new market and eventually striking it rich by selling to a strategic buyer or by offering stock to the public.

Dan was a realist. He knew that most of these advantages would be temporary. He understood that they had very little leverage in bargaining with customers or suppliers, particularly content owners. Although individuals would be the final consumer of their products, their immediate customers were larger retailers (e.g., Wal-Mart and Best Buy and software distributors such as CompUSA). GWM was largely at the mercy of retailers who would give those products the greatest exposure on their shelves. The core of GWM's business was an idea that could be copied readily, because there were few hurdles preventing others from entering the business, including brassy start-ups as well as the firm's own customers and even suppliers.

Figure 14-1 summarizes Dan's assessment of the competitive dynamics in the electronic publishing industry. Content was king and owners of sought after content were in a position to license it to the highest bidder. GWM's limited cash position put it a distinct disadvantage in dealing with content owners. Morever, competition for multimedia programmers was intense. GWM had to rely more on the prospect of striking it rich by offering potential employees options that could be exercised when the company was taken public. However, it could not afford the salaries being offered by the larger, more established firms such as Microsoft and Activision. With respect to competitors, GWM lacked access to reasonably priced content and distribution in contrast to several of the firm's competitors. While GWM had some degree of brand recognition, it was in a relatively narrow market niche, which limited long-term growth potential. While GWM's products were perceived by customers to be high quality, GMW had relatively little pricing power due to the slow acceptance of its product.

Dan decided to address the firm's limited access to content first. His options were limited by the lack of funds. He could develop the content internally and then pay a license fee to use the artist's name. He realized that this would require substantial time and effort to hire the right
talent and negotiate a license arrangement. He thought he could solve this problem and also his concerns about the lack of a cost-effective distribution channel by directly contacting major music publishing companies. Such companies frequently owned the rights to certain music

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libraries, were in a position to convince the artist to promote the CD-ROM, and had the financial wherewithal to aggressively advertise the product.

GWM was continuing to receive significant fee income from the multiyear contracts it had signed with Apple, IBM, Sony, and others to promote their multimedia products, but this was insufficient to fund GWM's move into the electronic publishing business. Dan, the consummate salesman, was able to get sufficient additional funding through an initial public offering of the company's stock in mid-1993. The timing was right for new technology companies coming to market. Moreover, GWM was one of the few that were profitable as a result of its multi-year fee-based contracts. By late 1993, GWM had introduced several CD-ROMs. The acceptance of the new music CD-ROMs showed great promise. Sales more than doubled between 1993 and 1995. Revenue and net income reached $21 million and $450,000, respectively, in 1995.

Emboldened by this success, Dan and his staff worked feverishly to flesh out GWM's business expansion strategy. The essence of GWM's business plan was to grow through the rapid introduction of high-quality multimedia disks targeted at relatively narrow market segments. Revenue and profit growth would come from increasing GWM's penetration into the music entertainment CD-ROM publishing segment and then expanding into related electronic publishing segments. The central strategic question on Dan's mind was how best to achieve this growth: through internal development, through alliance, or through acquisition?

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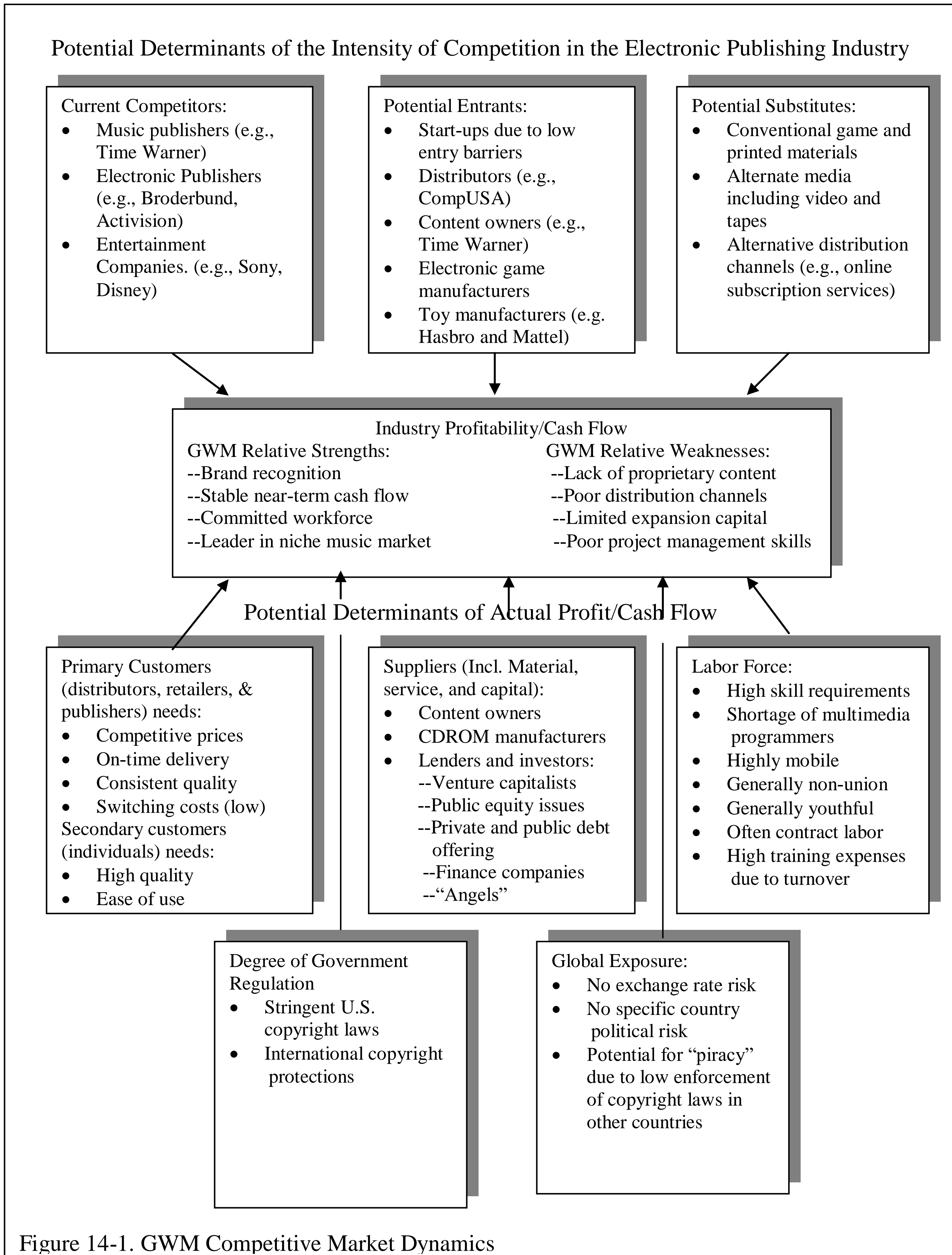

Figure 14-1. GWM Competitive Market Dynamics

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The Inevitable Need to Fund Future Growth

To fuel high growth, GWM had to continue to sign more artists, expand staff, increase the size of their facility, and augment their promotion and marketing budget. Although the future continued to hold great promise, the dynamics of the market were changing. By late 1996, industry-wide sales began to slow. GWM's market niche was not immune. Other companies were churning out similar products. The market was getting crowded. Predictions of a multi-billion dollar market by the end of the decade were simply not panning out. Despite the entry of other companies into the marketplace, GWM was able to sustain strong sales and profit growth as a result of its high product quality and excellent brand recognition. However, Dan knew that GWM could not continue to grow faster than the market for very long, especially in the face of increasing competition. Increasing capital outlays and working capital requirements caused free cash flow to deteriorate.

A review of what successful players in the industry were doing convinced Dan that he had to change GWM's formula for success. Go Go Technology (GGT), the fastest-growing industry participant, and Multimedia, Inc., the largest player, were continuing to grow. Unlike others, they were focusing primarily on programming while allowing others to manufacture the disks. Marketing was done largely through alliances with major software companies such as Broderbund, which was well known in the industry. GGT had done an excellent job in entering exclusive marketing relationships with some of the best-known software firms in the nation.

Dan was convinced that the market was moving too fast for him to outsource his development activities and to broaden his product line through purchasing or developing additional content. He felt that he did not even have the time required to enter into strategic marketing arrangements with the major software firms and publishing companies. Such arrangements could take months to negotiate, and the results were highly unpredictable. Dan believed that the multimedia industry was ripe for consolidation. The cost of developing, buying, or licensing content was becoming too great for the smaller players to survive. Dan carefully considered other options such as the sale of all or a portion of his company to a larger company. But GWM was still his baby. It was his dream, and he wanted to retain control until his dream was realized. In late 1999, his worst fears were realized when Multimedia, Inc. acquired Fly-By-Nite, Inc. for $15 million. The consolidation phase in the industry that Dan had feared was under way.

Gee Whiz Media Looks to Grow Through Acquisition

Early in the process, Dan and his board of directors decided to stay within the industry they understood. They continued to believe in the long-term promise of multimedia applications. Furthermore, they believed that by staying with what they understood they were more likely to achieve the goals laid out in GWM's business plan. It had become clear to Durand that an acquisition would be the best route to restoring GWM's earlier meteoric growth. Dan enlisted the aid of Kathryn Kim, a senior partner at a respected regional investment banking firm, and proceeded to develop a plan involving an acquisition as the primary means of realizing GWM's business plan. As envisioned by Dan, the acquisition plan really would provide the detail required to implement successfully GWM's business plan through an acquisition strategy. The acquisition plan provided both financial and nonfinancial objectives, GWM's resource limitations, further

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definition of the target industry, and what the firm was willing and not willing to do to complete the acquisition.

As outlined in GWM's business plan, management's primary strategy was to gain market share by extending its existing product line capabilities for converting content focused on niche markets into highly entertaining and interactive multimedia experiences. The means of accomplishing this was through the medium of the CD-ROM. An acquisition was viewed as the best way to implement the business strategy rapidly.

Setting Acquisition Plan Objectives

To implement this strategy, GWM established a number of non-financial objectives for an acquisition. A target firm must either own significant content or have access to proprietary content; possess effective distribution channels; and have excellent design and production capabilities. GWM's also stated that an acquisition would have to earn its cost of capital, which Kathryn Kim had estimated to be 15%; EPS dilution of the combined organizations would be limited to no more than 2 years following the closing date; and the combined firm's return on total investment would within 3 years exceed that which GWM could have achieved if it had remained independent. Having established acquisition plan objectives, its own resource limitations (e.g., limited management expertise), and the target industry, GWM set about defining the best way to make the acquisition.

<B>Defining Management Preferences<B>

GWM's management knew how much risk they were willing to accept. They did not want to invest so much that a single misstep could bankrupt the business. Consequently, they defined what they were willing and not willing to do in pursuing an acquisition by outlining the following considerations:

- GWM would not be willing to pay more than $100-$200 million for an acquisition.
- Financing the transaction would not violate existing loan covenants or materially increase GWM's borrowing costs.
- GWM would look for other CD-ROM companies with widely recognized titles whose growth had matured. Dan believed that it would be easier to rejuvenate old but well-known titles than to build widespread recognition around new ones.
- Only friendly transactions would be considered.
- Current competitors would be considered as potential targets.
- Ownership would be at least 51% of the acquired firm's outstanding equity.
- The maximum price-to-earnings ratio (P/E) of the acquired company could not exceed 30 times the current year's earnings.
- The fixed payment (i.e., interest, lease, and principal payments) coverage of the combined companies could not fall below the industry average of 1.0. GWM's management believed the company's attractive fixed payment coverage ratio (almost 2.0 at the end of 2000) would not result in any reduction in their credit rating by the investor community.
- A maximum of one-half of the present value of projected cash flow resulting from synergy would be counted in the purchase price. GWM's management believed that although they would be conservative in their estimate of synergy, history consistently has demonstrated that

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acquiring companies tend to realize only a portion of anticipated synergy in the desired period. Also, some portion of the projected synergy should accrue to GWM's shareholders rather than all of it going to the acquirer's shareholders for the deal to make sense.

Part II: Implementation

Initiating the Search for Acquisition Candidates

The deterioration in GWM's free cash flow from operations, slower than expected market growth, and intensifying competition caused the firm's share price to flounder. GWM's management knew that they would have to strictly adhere to realistic expectations of what the firm could pay for an acquisition. With Kim's assistance, GWM's management team set about determining appropriate criteria for selecting potential acquisition candidates. The primary selection criteria included target industry, size, price range, profitability, and growth rate. Kim cautioned against adding more criteria at this point in the search. "Too many selection criteria," she warned, "could eliminate all potential prospects."

In establishing secondary selection criteria (i.e., those used to reduce the long list developed by applying the primary criteria), Kim advised GWM to focus on targets whose cash flow, asset base, or lack of leverage could be used to finance the acquisition. This was particularly important in view of the deterioration in GWM's own cash flow from operations. A "short list" of potential acquisition targets was developed following a search of Kim's in-house database of companies, a review of industry literature, and confidential inquiries to GWM's board members as well as law and accounting firms. Current competitors and potential entrants into the market were given particular consideration.

GWM conducted a "peer analysis" to compare its own performance with that of other industry performers. This peer-review process would serve as an important component of the process for searching for acquisition targets. Although it was very difficult to get such data as market share, Dan had ready access to financial information on his primary competitors, which were all publicly traded companies. Dan was aware that financial performance could fluctuate widely because of seasonal factors or accounting reserves. Therefore, he insisted on viewing the trend in key financial indicators by averaging the data over a 3-year period. This had the effect of smoothing out fluctuations in the data (see Table 14-1).

With this information in hand, Durand was prepared to initiate "first contact" with firms on the "short list." Whenever possible, contact would be made through a trusted intermediary such as a GWM board member, the company's law or accounting firm, or Kathryn Kim. He made it clear to all involved that, at this stage in the process, secrecy was of paramount importance. He did not want to create concern among GWM's employees, suppliers, or customers. In addition, he did not want the "marketplace" to get wind of his intentions, which could drive up market values of potential acquisition targets. Professional arbitrageurs frequently made fortunes by buying on rumors and selling shortly before or after a transaction was complete.

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First Contact

After a somewhat frustrating 2-month search, GWM reduced what had been a lengthy list of 12 candidates to 2. The list was reduced because the companies did not fit the selection criteria as well as GWM had wanted or because they had rejected GWM's initial overtures through its intermediaries. At Dan's request, Dana Davies, one of GWM's board members, contacted her former business associate, Barry Chang, the CEO of GGT. Chang said that GGT might be willing to be acquired under "the right conditions." Kathryn Kim recommended further research into GGT's competitive market position and the goals of major shareholders and management before approaching GGT with a formal proposal.

The secret to GGT's success appeared to be its ability to outsource programming activities to service bureaus employing armies of highly skilled software programmers in India and the Philippines. Their hourly rates were a fraction of what domestic software engineers demanded. Moreover, GGT was able to diversify into other types of content to expand its product offering because of significant savings in developing software. Finally, GGT had done an excellent job of developing marketing relationships with some of the major software companies.

GGT was following a different business model from other companies in the industry, and Wall Street analysts were taking notice. GGT's approach to this business was to program the disks and have a larger publisher (like Broderbund) distribute them. Other companies such as Fly-By-Nite, Inc., Hype-O-Tech, and Hi Flyer Corp. chose to bear nearly all of the costs for programming and distributing the discs. The attractiveness of the GGT business model resulted in an equity valuation more than three times GWM's at the end of 2000. Although the two had grown both earnings and revenue at about the same pace in recent years, investors believed that only GGT would be able to sustain their growth rate through the foreseeable future.

Although GGT was the industry's current "Wall Street darling," a recent speech by Barry Chang at an industry trade association meeting implied that GGT's management was anything but smug about its current market position. By "reading between the lines," Dan believed that Barry was becoming increasingly concerned that Multimedia, Inc., the industry's behemoth, was likely to erode GGT's position by adopting many of the tactics used by GGT. Indeed, Multimedia, Inc. had publicly pronounced in an interview with its chief executive officer (CEO), Carl Widman, that its strategy was to adopt the best practices in the industry and to improve on them.

After further conversations between Davies and Chang, Dan believed that it was time for a face-to-face meeting with Chang. At that meeting, Dan presented the argument that together their two companies could present an effective counterweight to Multimedia, Inc. Dan wanted to play to Chang's concerns. "Individually," he argued, "their competitive positions were problematic in the long run given the apparent slowdown in industry demand. But together they could benefit from Gee Whiz Media's excellent content library and GGT's lower cost of designing, developing, and marketing CD-ROM products." Chang seemed to be impressed by Durand's compelling logic.
At the end of the meeting, Dan and Barry agreed to sign a confidentiality agreement that would include both parties and to exchange summarized business plans and financial statements for their respective companies. Dan was very interested in seeing in more detail what GGT had done over the last few years and thought it could do over the next few years; Barry was interested in

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evaluating GWM's ability to finance a transaction. Even before GWM began its due diligence review of GGT, Barry initiated a due diligence of his own operations to ascertain exactly what representations he could make if the negotiations reached the stage of a final agreement of purchase and sale. Barry also had his key managers sign affidavits stating that to the "best of their knowledge" what they said about the GGT operations was indeed true.

Dan and Barry also laid out a timeline that would enable GWM to perform a modest preliminary due diligence review. At the end of 30 days, GWM would have to provide a formal letter of intent containing a specific purchase price. Although the letter of intent would be binding, it would contain the standard protections for both parties. GGT would agree not to "shop" for another suitor during the 60-day period the letter of intent was in force, and GWM's offer price would be contingent on performing a more thorough due diligence, gaining a commitment from lenders, and obtaining the requisite board and shareholder approvals.

Preliminary Valuation

Dan and his CFO, Andy Perez, poured over the 5 years' worth of audited statements that they had received from GGT. Dan expressed some disappointment that the cash-flow numbers tended to jump around from year to year. He was hoping that GGT could demonstrate a stable, predictable cash-flow stream. Predictable cash flows, he reasoned, would enable GWM to convince bankers that GWM could assume significant leverage to purchase GGT for cash and still be able to meet debt service requirements easily. Perez was quick to point out that much of the variation in historical cash flows was the result of nonrecurring or one-time events. For example, he explained that GGT's cash flow was affected negatively in 1997 by a $1.9 million expense associated with an out-of-court settlement of a software copyright infringement lawsuit filed by Fly-By-Nite, Inc. In 2000, free cash flow benefited from the sale of a proprietary software license for $4.5 million to another firm. Perez assured Durand that if the historical numbers were restated to eliminate the one-time occurrences, GGT's cash flow would show a smooth upward trend.

Dan designated Perez as the acquisition project leader with clear authority to draw on others with specialized skills throughout the organization. Perez was quick to establish action teams dedicated to specific aspects of the negotiation process. These teams included financial analysts to refine the initial valuation of GGT and a combined legal and financial team to work on structuring the proposal to GGT's management. Other teams included a multidisciplinary group to conduct due diligence consisting of operations, marketing, and accounting experts and a team consisting of Perez and GWM's treasurer to develop a plan for financing the acquisition. Dan viewed the financing plan as a critical component of the negotiating process, because it placed a realistic limit on what he could offer GGT's management and shareholders.

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Table 14-1. Comparative Financial Performance Ratios (1998–2000 3-Year Average)[1]

	Gee Whiz Media	Go Go Technology	Fly-By-Nite, Inc.	Hype-O-Tech	Hi Flyer Corp.	Multimedia, Inc.
Profitability Ratios						
EBIT/Sales[2]	.136	.190	.028	.067	.019	.098
Net Income/Sales	.06	.108	.009	.048	.008	.076
EBIT/Total Assets	.186	.279	.041	.121	.031	.187
Net Income/Equity	.294	.248	.068	.169	.052	.220
Net Income CAGR[3]	.354	.359	–.028	–.014	–.044	.196
Activity Ratios						
Sales Growth	.301	.348	–.031	–.021	–.036	.089
Sales/Assets	1.4	1.48	.98	1.11	1.63	1.32
Liquidity Ratios						
Current Assets/Current Liabilities	4.42	4.22	1.61	2.51	1.52	1.86
Working Capital/Sales	.320	.334	.229	.321	.324	.226
Financial Leverage Ratios						
Debt/Total Assets	.586	.215	.816	0.767	0.823	.398
Debt/Total Capitalization	.679	.251	.922	0.883	0.899	.456
Fixed Payment Coverage[4]	1.27	2.90	.886	1.27	1.07	1.49
Market-Based Ratios						
Price/Share ($)	40.30	32.50	3.77	19.24	9.60	66.22
Price/Earnings	16.1	18.1	11	14	10	15.6
Earnings Per Share ($)	2.50	.60	0.19	0.66	0.16	3.01
Price/Revenue	1.04	1.95	0.9	1.3	0.8	1.6
Price/Book	4.74	4.47	.89	2.13	2.88	2.89
Price/Cash Flow[5]	NA	NA	45.6	35.7	NA	19.6
Market Capitalization						
Market Value ($)[6]	33,000,000	103,500,000	12,565,000	28,462,000	17,239,000	368,990,000

[1]Based on normalized financial performance.
[2]Earnings before interest and taxes
[3]Compound annual average growth rate.
[4](EBIT + Lease Payments)/(Interest Expense + Lease Payments + Principal Repayments × (1/(1 – .4))
[5]NA = not applicable because average free cash flow is negative during this period.
[6]Yearend 2000.

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Dan was pleased with the appearance of highly predictable cash flows for GGT between 1996 and 2000. He was, however, quite skeptical of the 32.6% and 28.6% compound growth rate GGT projected for net income and sales, respectively, between 2001 and 2005. Once again, Perez—being the consummate numbers person—cautioned that Dan should reserve judgment until the assumptions underlying the forecast were well understood. Following several days of hectic number crunching by Perez's minions, Perez reported to Durand that the assumptions looked reasonable except for what appeared to be an overly optimistic improvement in the ratio of the cost of goods sold to net revenue built into the forecast period beginning in 2002. This was evident on examination of the common-size income statement, which showed how the projections deviated from GGT's actual historical performance.

Chang was questioned about the realism of this assumption. "This reduction," he explained, "reflected the implementation of a modular software development system that GGT had been working on for several years. This system would enable GGT's developers to more readily reuse existing software code in new product introductions. The resulting reduction in coding time would substantially lower product introduction costs." Dan was familiar with software development projects, and he was well aware that they frequently were implemented well behind schedule and considerably above budget. Furthermore, his experience led him to believe that these types of projects rarely provide the productivity improvements that are expected. Consequently, Dan told Perez to rerun the GGT projections but with more modest growth assumptions and with the cost of goods sold as a percentage of sales in line with the company's historical performance. This, he believed, would provide a more realistic picture that did not depend on what Dan thought were largely heroic assumptions. Despite its significantly smaller size in terms of revenue, the preliminary discounted cash-flow standalone value for GGT was $102.7 million, about $6 million more than the market value (including debt) of GWM.

Identifying Sources (and Destroyers) of Value

With the revised forecast, Durand and Perez turned to identifying "hidden" sources of value that GWM could unlock to provide additional cash generated by the combination of GGT and GWM. To identify these sources of value (measured in terms of incremental cash flow), Perez and his associates poured over GGT's financial statements and operations looking for assets not recorded on the books at fair value, underutilized borrowing capacity, and the potential for cost savings (e.g., shared overhead, duplicate facilities). Other potential sources of value included new customer relationships; opportunities for GWM to use new technologies and processes; and intellectual property such as patents, trademarks, and royalty rights. They also looked for factors that would reduce future cash flow such as product quality problems, employee turnover, duplicate customer relationships, and so on.

The present value of total synergy was estimated at $118 million. Very little of the anticipated synergy was expected to be realized during the first full year of GWM's ownership. The full impact was not expected until the third full year of combined operations of the two firms. A third-party marketing firm was hired to interview a representative sample of GGT customers without divulging that they were hired by GWM. Rather, customers were told, with GGT's blessing, that the marketing firm was conducting a survey for GGT so that the company could better understand its customers' needs.

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Assumptions made about factors contributing to future cash flows of the combined firms and those detracting from future cash flows were clearly delineated in Perez's presentations to Durand. Moreover, these assumptions would be validated carefully during the more exhaustive on-site due diligence that was to take place before closing.

Determining the Initial Offer Price

Perez's approach to valuation involved a four-step procedure. Initially, GWM and GGT were valued as standalone businesses, with all operating revenues and costs stated at market prices. In the second step, the present value of net synergy was determined by subtracting the sum of the standalone values of GWM and GGT from the present value of consolidated GWM and GGT, including the effects of estimated synergy. The third step entailed the determination of the initial offer price, which was equal to the minimum offer price (i.e., GGT's current share price times total shares outstanding) plus the percentage of estimated net synergy GWM was willing to share with GGT shareholders. Finally, Perez determined if GWM could finance the transaction at the initial offer price determined in the third step.

This initial offer price would be further validated by comparing the discounted cash-flow valuations with purchase prices based on P/E, price-to-revenue, and price-to-book ratios for recent transactions involving comparable companies. These ratios seem to confirm that $150.6 million ($50.20 per share) was a fair price for GGT's outstanding equity. This price represented a 46% premium over GGT's current share price of $34.50

Table 14-2. Offer Price Determination[1]

Financing Metrics	Standalone Value		Consolidated GWM and GGT		Value of Synergy
	GWM (1)	GGT (2)	Without Synergy (3) (1) + (2)	With Synergy (4)	PV Net Synergy (4) – (3)
Valuation ($Mil.)	72.8	99.6	172.4	290.2	117.9
Minimum Offer Price ($Mil.)	103.5	GGT share price ($34.50) at close of business day before offer presented to GGT management × number of GGT shares outstanding.			
Maximum Offer Price ($Mil.)	221.4	Minimum offer price plus 100% of estimated net synergy			
Initial Offer Price ($Mil.)	150.6	Minimum share price + 40% of estimated net synergy, where .4 is portion of synergy GWM initially is willing to share with GGT shareholders.			
Initial Offer Price Per Share ($)	50.20	Initial offer price/number of GGT's shares outstanding			
Purchase Price Premium Per Share (%)	.46	Initial offer price/current GGT share price			

[1]For the detailed financial statements underlying this table and others in Chapter 14, see Case Study 8-1 (Chapter 8) entitled "Determining the Initial Offer Price—The Gee Whiz Media and Go Go Technology Saga."

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Dan reasoned that a substantial premium over GGT's current share price would preempt other potential bidders from making a "run" for GGT. The last thing Dan wanted at this time was a protracted and contentious bidding war for GGT. Dan knew that GWM did not have the financial resources to outbid companies the size of Multimedia. Nonetheless, even with this lofty premium, the GGT acquisition looked attractive, promising to boost the market value of the combined companies to almost $300 million, including about $118 million in estimated synergy. The expected synergy consisted of a combination of revenue enhancements and cost savings. The additional revenue was expected to come from improved product quality, a broader product offering, and cross-selling to each firm's customers. Production cost-related savings would result from economies of scale (i.e., better utilization of existing facilities) and scope (i.e., the use of existing operations to more products), as well as the elimination of duplicate jobs.

Deal Structuring

Dan knew that a stock-for-stock purchase was problematic because of the potential dilution in GWM's EPS. Wall Street analysts increasingly viewed GWM's above-average industry growth rate as suspect. With the industry growth slowing, they reasoned that product pricing was likely to get very competitive. Although GWM had been able to maintain attractive margins in recent years, the lack of new products that had blockbuster potential made the analysts increasingly wary of the firm's ability to sustain both high growth and attractive margins. Continuing delays in introducing new products, the lack of exclusive distribution channels, and the firm's limited proprietary content library heightened this concern.

An acquisition resulting in dilution was not likely to be acceptable to Wall Street. With long-term debt comprising about 60% of total capital, an all-cash transaction did not seem possible. Durand and Perez had to be creative to reduce the initial cash-flow impact of the acquisition on GWM. Consequently, it seemed increasingly obvious that GWM would have to convince GGT that some combination of stock and cash for GGT would be attractive. They would need to know what GGT's management and shareholders would be willing to accept. This required some old-fashioned detective work, such as reading old speeches made by Chang at trade shows and shareholder meetings, reading Wall Street analysts' reports and SEC filings, and looking at the amount of GGT stock accumulated by the company's top management. Given the youth of many of GGT's top managers, GWM felt that they would find stock in the new company attractive enough to remain with the firm beyond closing.

Although Durand wanted to retain several key GGT managers, he believed that in the long term, personality conflicts would arise as a result of his way of doing business and Chang's hard-charging, sometimes "bend-the-rules" approach to things. Moreover, Chang's salary was the highest in the industry; Durand thought it was out of line for what Chang could contribute as a senior manager to the combined firm's ongoing operations. Dan Durand was willing to consider management employment contracts to retain key managers, but he did not want to keep Chang.

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Durand, Perez, and their investment banker began to brainstorm different scenarios involving alternative purchase price compositions. They knew that if an exciting "story line" could be created for the combined companies, it would be possible to convince GGT's shareholders to accept something other than an all-cash or all-stock offer. Indeed, a combination of stock and cash might appeal to a wider range of GGT shareholders. GGT shareholders could continue to hold GWM stock to participate in the potential appreciation, while using the cash portion of the purchase price to diversify their investment portfolios or to satisfy any short-term cash requirements they might have.

To determine the appropriate composition of the initial offer price, GWM's management reviewed 15 alternative scenarios. GWM's own analysis suggested that its standalone equity value could total about $73 million, even without the acquisition of GGT, if their assumptions underlying their current 5-year projections turned out to be correct. Obviously, GWM's management and shareholders would have to be convinced that they could do markedly better to justify the risk associated with acquiring GGT.

Certain financial scenario selection criteria were established to determine the preferred scenario. The most acceptable scenario would be the one that resulted in the highest net present value, the least EPS dilution, substantially exceeded what GWM could have done without GGT in terms of after-tax returns on invested capital, and would most likely be acceptable to shareholders. Moreover, the scenario could not jeopardize the combined companies' ability to satisfy loan covenants or maintain fixed payment coverage and debt-to-total capital ratios consistent with the average for other companies in the industry. All-cash and all-stock offers were included in the analysis (although it was felt that neither was a realistic option) as benchmarks or baselines for comparing the other options. The most attractive scenario to GWM consisted of 1.14 shares of its stock plus $12.55 in cash for each share of GGT's stock.

Negotiations Heat Up: Refining the Offer Price

Although this offer had great appeal from GGT's perspective, the transaction would create a significant tax liability for GGT's shareholders. Dan learned very quickly from Chang that this could be a stumbling block. Although he did not mention it to Chang at this point, Dan was willing to increase the number of GWM shares offered for each GGT share. He also was willing to share up to one-half of the expected synergy if he had to in order to complete the transaction. Chang made it clear that, although Dan's proposal was "in the ballpark" on a pretax basis, it was wholly inadequate on an after-tax basis. Much of GGT's stock was held by a relatively few shareholders that had a very low tax basis in the stock. Consequently, their tax liabilities from a taxable transaction would be substantial. Chang indicated that Dan either would have to raise the total price on a pretax basis to compensate for any tax liability or increase the equity portion of the offer price, thereby softening the potential tax bite to GGT shareholders. Dan agreed to review his options and get back to Chang. Dan knew that "in the ballpark" meant that Chang was looking for a higher price on both a pre- and after-tax basis. He and Perez would have to be creative to satisfy Chang's demands.

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Developing Counter Offers

Subsequent analysis indicated that it would be difficult for GWM to increase significantly the share exchange ratio without savaging EPS of the combined firms. Dan and his board of directors did not find these results acceptable. However, GWM was willing to "sweeten" their initial offer by assuming all of GGT's long-term debt, which totaled $3.2 million. Although this change in terms did not address specifically Chang's concern about taxes, it did add to the overall purchase price being offered. Without GWM's assumption of this debt, GGT would have to repay this amount to lenders from the cash portion of the purchase price (see Table 14-3).

Table 14-3. Determining the Composition of the Offer Price	
Cash Per Share ($)	12.55
Share Exchange Ratio[1]	1.14
New Shares Issued by GWM[2]	3.42
Total Shares Outstanding (GWM/GGT)[3]	4.42
Ownership Distribution in Combined Firm	
GGT Shareholders (%)[4]	.77
GWM Shareholders (%)	.23
Offer Price Composition Per Share	1.14 shares of GWM stock + $12.55 for each GGT share outstanding
Offer Price Including Assumed GGT Debt[5] ($ Millions)	153.8

[1]Number of GWM shares to be exchanged for each share of GGT stock.
[2]Share exchange ratio times the number of GGT shares outstanding (i.e., 3 million).
[3]GWM's existing shares plus the new shares issued to acquire GGT.
[4]Number of GWM shares held by GGT shareholders divided by total shares outstanding for the combined firms (i.e., 3.42/4.42).
[5]GGT's outstanding long-term debt at the time of the proposed acquisition totaled $3.2 million.

Although Barry Chang initially expressed disappointment with the offer, he agreed to present it to his board of directors. GGT's board and shareholders found the improved offer acceptable, because it was substantially nontaxable, offered a significant premium over the firm's current share price, and represented an increase (albeit small) of 2.1% (i.e., $153.8/$150.6) in the initial offer price. Durand was happy because he was able to move the deal along without raising the total purchase price to levels that were clearly unjustifiable.

<B>Due Diligence: Looking for a Needle in a Haystack<B>

Durand was a "big picture" guy. He had little interest in details. He understood intuitively the need for a thorough due diligence, but he did not have the temperament to actively participate in such a time-consuming and laborious process. "Andy, you take the lead in due diligence," he barked. "I will attend to the day-to-day operations of GWM that have been neglected during the negotiations." Andy Perez reminded him that due diligence was extremely important to confirm the "sources of value" assumed in the valuation, identify other potential sources of value, and identify any "fatal flaws" that would reduce future cash flows. Perez urged him to participate at least in the interviews of senior GGT managers. Perez quipped, "What we don't know can hurt us." Dan reluctantly agreed to

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participate. He understood that, until due diligence had been completed, they would really not know what they didn't know.

Perez organized three teams to conduct due diligence: a financial team, a strategy team, and a legal team. He asked Dan to direct the strategy group; he would handle financial matters, and the attorneys would handle the legal affairs. The strategy and operations teams' responsibilities were to review past business and operating plans to evaluate actual performance to plan (a measure of the competence of management), to evaluate the effectiveness of sales and marketing plans, and to assess customer relationships. In addition, the team was to evaluate the integrity of operations in terms of facility design and layout, software design and development capabilities, and project management skills. Much of this was to be accomplished through a series of personal interviews with midlevel and senior management.

The financial team would concern itself with the integrity of GGT's books (i.e., are they stated in a manner consistent with generally accepted accounting principles, or GAAP) and would conduct an inventory of assets to substantiate their existence and to evaluate their quality. Perez was aware that significant variations from GAAP, as is often the case with the increasingly common use of so-called pro forma statements, could signal that the selling firm was trying to hide something (e.g., true profitability or questionable accounting practices). The legal team would review corporate records, material contracts and obligations of the seller, and current and pending litigation and claims. Each team developed a question checklist to ensure that the due diligence activity was comprehensive.

Following an extensive review of GGT's operations and books, several areas of concern as well as opportunities emerged. Revenue recognition appeared that it might become an issue. This traditionally has been a problem with software companies where products frequently are shipped to distributors on consignment or where service contracts and upgrades can stretch revenue out for years. GWM accountants noted that GGT might have been booking revenue too quickly. When disks were sent to retailers, allowance for the return of unsold disks from the retailers should have been taken into account. Booking revenue too early provides an opportunity to inflate current sales and earnings at the expense of future earnings.

Areas that provided an opportunity for GWM included in-process research and development (R&D) charges. These could be taken by GWM at the time of the acquisition. These charges represent the estimated value of R&D at the target company. Because it is still "in process," the research is not yet commercially viable. Because it may prove worthless, it all can be written off. By separating the expenses from revenues that might be gained in the future from the R&D, however, future earnings can get a big boost. Moreover, a portion of goodwill arising from the purchase could be offset by the common practice of writing off in-process R&D charges.

As a result of its own internal due diligence activity, GGT felt comfortable with the accuracy of the representations and warranties it was prepared to make in the agreement of purchase and sale. Because GWM was well known to Barry Chang and his management team, their review of GWM's ability to finance the acquisition was limited.

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Obtaining Financing: Lend Me the Money, Stupid!
It's a great deal. Just lend me the money you dunderheads," thought Dan as he and Perez pitched the acquisition proposal to lenders. To raise money, Durand and Perez had to go on the typical road show to make presentations to banks, insurance companies, pension funds, and the like to raise funding. They would need to borrow about $40 million to finance the cash portion of the purchase price. Their challenge was to convince bankers that the cash flow of the combined companies could meet debt service requirements. In the electronic publishing business, few companies had a sufficient amount of tangible assets to serve as collateral. Consequently, lenders focus on the amount and predictability of free cash flow (i.e., cash generated in excess of normal working capital, capital expenditures, and other fixed obligations).

The combined companies' total debt was expected to reach $70.5 million, including transaction-related debt totaling $40 million. Loan covenants on existing debt require that the new firm's debt-to-total capital be less than one, fixed payment coverage charges be greater than one, and current assets be at least twice current liabilities. At the end of 2001, the new firm's financial ratios complied with the covenants.

After extended negotiations, a bank agreed to an unsecured loan to GWM of $40 million amortized in equal payments over 15 years at an annual interest rate of 11%. The loan was subject to normal covenants, which restricted the amount GWM could borrow in the future and the types of spending it could undertake without the bank's approval. Furthermore, GWM would have to ensure that certain other financial ratios such as earnings before interest and taxes as a multiple of interest expense did not fall below a contractually determined multiple. Durand felt the covenants would restrict his ability to manage GWM in the future as aggressively as he might want. This provided an incentive for him to use the majority of future free cash flow to accelerate repayment of the loan. He knew that the loss of some control and strategic flexibility was the price he would have to pay to complete the transaction.

Integrating the Organizations: Communicate! Communicate! Communicate!
Despite the perceived compatibility of the cultures of the two firms, Durand knew from experience that combining the firms would lead to inevitable concerns, particularly among GGT employees, about job security and compensation and about how the new firm would be managed. Although one could expect to lose some key employees to competitors following the acquisition, Durand felt that the situation was manageable if the proper planning was undertaken. He had to start by clearly communicating his own priorities to his subordinates and establishing an appropriate integration team infrastructure.

Before closing, he appointed Amy Pettibone, one of his best operating and project managers, to oversee the operational combination of the two firms once the transaction had been completed. Amy had a demonstrated ability to set and communicate priorities, to size up people accurately, to make tough but fair decisions, to establish a timeline, and to stick to even the most ambitious schedule. These were managerial skills crucial to successfully integrating businesses where differences in corporate cultures could be significant. Meshing the software development teams of the two companies would be critical to ensuring that the

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productivity improvements and acceleration of new product introductions envisioned in GWM's acquisition strategy would be realized. Amy was assigned to head the strategy and operations team during due diligence to familiarize herself with the challenges of integration.

Based on the information collected during due diligence, Amy Pettibone and Andy Perez worked closely to determine what near-term expenditures might be required to ensure that GGT's operations would continue without interruption during the next 12–24 months. This included the identification of key managers that were to be retained, key technologies, and a review of vendors and customers. The pair also reviewed industry-wide operating norms to determine other adjustments that might have to be made in the immediate future. These norms included executive compensation, billing procedures, product delivery times, quality metrics, and employee benefit and compensation packages. Retention bonuses were offered to employees, who were to be terminated within the first full year following the closing, to stay with the firm during that period to ease the integration of the two firms. Such bonuses were equal to as much as 6 months of the employees' salary and benefits, depending on their importance during the integration period.

GWM's management knew that the time to address these issues was before the closing. Issues such as severance expenditures, pension plan buyouts, employment contracts, capital expenditures that should have been made by GGT as part of the "normal course of business," noncompete agreements, and so on, should be addressed as part of the negotiation process. When appropriate, GWM would seek a reduction in the purchase price as at least a possible offset to these types of expenses that were not apparent when the preliminary indication of value for GGT was given in the letter of intent.

Perez was interested in ensuring a smooth transition for all employees immediately following closing. Consequently, he wanted to make sure that all GGT employees would be transferred to current GWM benefit programs and that payroll information was transcribed accurately to the GWM personnel database so that payrolls could continue to be processed without disruption despite the change in ownership. Finally, Perez knew that GGT lock boxes had to be closed and that former GGT banks had to be instructed to forward any checks they might receive from GGT customers to GWM lock boxes.

Key managers at GGT were offered 1-year employment contracts with GWM. Retaining key GGT managers was considered important enough that Durand instructed his attorneys to make the acceptance of employment contracts by designated employees a "condition" of closing. Barry Chang also signed an agreement that he would not work for a competitor or start a business that could compete with the combined firms for a period not to exceed 3 years from the closing date.

Finally, a detailed communications plan was devised for use immediately following closing. The plan included press releases and announcements to employees (addressing questions about job security, compensation, and benefits), customers (providing assurances of an uninterrupted service), and vendors. Durand would speak to GGT employees at their headquarters to answer questions and provide reasonable assurances of continuity of pay and benefits. The lawyers cautioned Dan about not making verbal commitments about job

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security, which could result in litigation at a later date. In addition, "talk tracks" were written for the sales force, who were instructed to contact all major customers directly on the day of the announcement of the acquisition of GGT. Nothing was to be left to chance!

The Dream Comes True

The stress level rose sharply during the days just before closing. Heated negotiations were taking place around a number of issues that surfaced during due diligence. Several potential lawsuits involving disgruntled customers and employees had the potential of costing the new company millions of dollars over the next 3–5 years. Although it was not clear if they actually would go to trial, GWM estimated the future value of their potential impact to be $7 million to $10 million. In addition, the new company would have to spend $1 million to $3 million in normal maintenance and repair of GGT operations during the next several years. GGT's management had postponed these expenditures when the prospect of sale came up.

The combination of potential or pending expenses had an estimated present value of $10 million, consisting of $8 million in potential jury awards and $2 million in deferred maintenance. Because they had been identified late in the due diligence process, their impact had not been included in the projected operating cash flows used in GGT's initial valuation. Moreover, Durand was concerned enough about what was uncovered during due diligence that he wanted Chang to agree to put 5% of the purchase in escrow for at least 1 year until all the "surprises" were known.

Despite several days of aggressive negotiating, Durand capitulated and agreed to absorb these additional costs without any reduction in purchase price. Durand believed that the $10 million would be more than offset by certain nonoperating assets that were identified during the due diligence process. These included GGT's holdings of cash and marketable securities in excess of normal working capital requirements of $1.5 million and a series of process patents, software copyrights, and content licenses that were owned by GGT but were not being used in the operation of the company. Durand believed that by using these assets, the new company could save at least $12 million to $15 million in future expenses that would have been incurred to develop these processes and patents or to gain access to certain types of content. Moreover, GGT owned a piece of undeveloped commercial property that GWM believed could be sold during the next 12–18 months for approximately $3 million. The estimated present value of these nonoperating assets was $14 million (see Table 14-4). The equity value for GGT adjusted to include the estimated value of these nonoperating assets and liabilities totaled $103.6 million, $4 million more than the initial estimate made before completing due diligence. Besides, he was tired. He wanted the negotiations to end so that he could get on with the business of growing the combined companies.

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Table 14-4. Adjusted GGT Standalone Valuation ($ Millions)	
PV (2001–2005) @ 15%	6.7
PV of Terminal Value @ 10%	96.0
Total PV (Market Value of Firm—Equity + Debt)	102.7
Less Market Value of Debt	3.1
Equity Value	99.6
Plus Nonoperating Assets	
Excess Operating Cash & Short-Term Marketable Securities	1.5
PV of Undeveloped Commercial Property	2.5
PV of Unused Process Patents, Software Copyrights, and Content Licenses	10.0
Total Nonoperating Assets	14.0
Less Nonoperating Liabilities	
PV of Potential Jury Awards	8.0
PV of Deferred Maintenance	2.0
Total Nonoperating Liabilities	10.0
Adjusted Equity Value	103.6

Once the respective companies' boards of directors and shareholder approvals were received, customer and vendor contracts assigned, financing in place, and other closing conditions satisfied, the closing finally took place. For the first time in 6 months both parties could relax. Congratulations were in order for all participants. Whereas Perez's stress level eased, Pettibone's escalated as she faced the challenges of meeting the demanding integration schedule. Durand's role changed from that of the dealmaker to that of the chief executive charged with meeting the expectations of his shareholders and Wall Street analysts. As the CEO of one of the major firms in his industry, Durand was trading one set of challenges for another. But he was happy—he was living his dream.

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