

CHIEF EXECUTIVE

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What M&A Banker Would Rather I Not Write

Methods that manipulate CEOs to pay more

Dr. Robert Lawrence Kuhn



If you are a CEO, you were my target. For more than 10 years, I ran a firm whose business was to sell small- and medium- sized companies, and to sell them for the very highest possible prices. During that time, we closed over 1,200 M&A transactions, and when we sought prime candidates to pay the most money, corporate buyers were almost always at the top of our hit lists.

One business owner complained to me that we had not valued his company for “more than it was really worth.” He wasn’t being funny: My company had a reputation—among corporate buyers not always a good one—of asking and often getting high prices for its sell-side clients.

How did our M&A dealmakers cajole or coerce tough-minded, market-hardened CEOs to shell out top dollar, sometimes paying more for the business than it was “really worth”? What were our techniques? Our tricks?

Though I may face disfellowship from the High Church of M&A Bankers, I’m going to reveal the M&A secrets of the inner sanctum: how top dealmakers manipulate CEOs to get them to pay too much. Here’s what M&A bankers do to you.

Discern the Decision Maker

If you are the CEO of a corporate buyer, dealmakers want to find your V (vulnerable) spot. Many CEOs are motivated more by power than by money; they are more concerned about the reputation they build than about the returns they earn. At the risk of channeling Gordon Gekko (a fictional character in the movie *Wall Street* who became a symbol of corporate greed), I’d always like to have CEOs, the prospective purchasers on the other side of the table, who were more motivated by ego than by greed.

Make Hockey Stick Projections

When M&A bankers represent sellside clients, they are under no obligation, unlike district attorneys, to present their cases based on all the evidence. A banker’s job is to get the highest price possible; smart, aggressive advocacy is essential for a freemarket economy. Whatever M&A bankers present should be the truth, but not necessarily the whole truth. When they make forecasts, they do not even pretend to be unbiased.

Sure, they try to be credible, but I can’t tell you how many of our financial projections looked like “hockey sticks”—three years of historical profits sliding steadily downward followed by five years of forecasted profits rising steadily upward. When M&A bankers provide projections, image them as criminal defense lawyers (or as masked goalies).

Conjure Up Strategic Fit

“Synergies” and “strategic fit” are the Holy Grail when bankers search for buyers willing to pay an outlier price. If you come to believe that you can eliminate most of the overhead of an acquisition, folding the purchased business into your own business, then the target’s gross margin can magically become its net margin. As a result, the price you are now willing to pay, assuming a similar multiple, escalates.

The reason corporate buyers pay, on average, more than do private equity groups is that CEOs imagine synergies that may not exist. Worse, such ephemeral synergies may become stealthy anti-synergies, the kinds that appear to be real but transmogrify on full-scale implementation and become toxic to the entire company.

One textile company bought a similar company assuming that the seller's products could be manufactured in the acquirer's underutilized plants. But since the product quality of the seller was higher than that of the acquirer, the products produced were inferior, customers fled, and the acquired business disintegrated.

Recast Aggressively and Without Doubt

This is a common technique, especially when selling private companies. In making projections, the idea is to eliminate expenses that the private business owner, who is motivated to reduce taxes, runs through the company. These include "excess compensation" that the owner may pay to herself or to her family members. Some such recasting is legitimate when this compensation, to be charitable, is "above market," but can the company really attract a quality CEO for the assumed lower compensation?

M&A bankers may use the term "normalize," which means to recast the financials by eliminating "onetime expenses" like unusual legal fees. Sure, companies do have "one-time expenses," but they may have them all the time—each specific expense may indeed be "one time," but the perennial existence of a neverending series of "one-time expenses" may be a "normal" part of the business!

Make Presentations Elegant

The more elegant the package, the more believable its contents. This sounds so contrived (or simpleminded) that no sophisticated CEO would fall for this. Wrong. Subtle psychological factors are at work and M&A bankers exploit them. After all, how could big, beautiful books from large, distinguished investment banks contain little, manipulating fibs?

Seduce the CEO

Nirvana for sell-side M&A bankers is when the acquiring CEO gets emotionally involved with the deal. "Has [X] fallen in love?" was a question we'd ask. We couldn't make you, Mr. CEO, begin to court our client, but once you asked for the first date, we knew how to puff your ego and make you feel great.

Never Appear Anxious

M&A bankers try to convince CEOs that their clients are not all that anxious to do the deal, that you the buyer want to buy more than the seller, the banker's client, wants to sell—a state of affairs that is often not the case. Anxiousness, which we often felt, was always masked.

Speed the Process

"Time Kills Deals" is one of our adages. For sellers, especially when small companies sell to large companies, a quick close is almost always best. You never know what can happen, what disruption lies in store. Change and surprise do not normally bode well for sellers. New financials are more likely liability than asset. If actuals do not meet forecasts, the buyer puts downward pressure on price and negotiates final contract terms more stringently. Alternatively, if actuals beat forecasts—a happenstance that occurs, nonrandomly, well less than 50 percent of the time—it is usually more difficult for the seller to raise the price.

Induce CEOs to Bid Against Themselves

This technique is a favorite that M&A bankers try to use regularly. Here's how it works: 1) You are the only viable buyer. 2) The seller is anxious to unload. 3) You keep sweetening the deal. The banker opens this lock with two keys: first, the buyer has to love the deal; and second, the banker has to convince the buyer that a hot auction is going on. Turning both keys leaves the fingerprint of a good banker.

Swamp Due Diligence

Due diligence is when the buyer checks the seller to make sure that what seems to be true really is true. It's nail-biting time for bankers who have calculated their fees and are waiting for the most opportune moment to submit their fee letter to their client. The deal has been negotiated; price and terms are set. Neither will get better during due diligence; they can only get worse.

Every company has warts and it is the job of the M&A banker, representing the seller, to make them blur with the background. Not difficult to find, but difficult to see. Difficult to find? That would be improper and could be illegal. But difficult to see? That's good representation. The idea is to so overwhelm the due diligence team of the acquiring company with paper—not boxes full of paper but rooms full of paper (especially on legal matters and assorted trivia). As a result, fundamental matters of business, like who will run the company after you make the current owners very rich, are not addressed.

Good bankers don't hide anything (knowingly), certainly not anything asked directly. It's not right and it's not practical: Any evasion appears as a giant neon sign arrow pointing to a serious problem. The best M&A bankers are always forthcoming, always answering every question and often doing so exhaustively with massive amounts of material.

It is a statistical fact that most M&A transactions erode the value of the acquirer. M&A bankers do not like you to know this. They talk synergy and strategy, and get you feeling grand. But now you know what you're up against. In the next issue, I'll present the Principles that Protect CEOs from Paying Too Much. Don't close your deal before then.

Dr. Robert Lawrence Kuhn was president and co-owner of The Geneva Companies, the largest M&A firm representing privately owned, middle market companies (in terms of number of transactions closed); in 2001, he sold Geneva to Citigroup, where he is now senior adviser to the Investment Bank (China). Dr. Kuhn has a doctorate in anatomy/brain research and is the author of numerous books on dealmaking and corporate strategy.

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Inside M&A Banking

How do you protect a CEO from paying too much?

Dr. Robert Lawrence Kuhn



The relationship between CEOs and investment bankers is like that of medieval popes with Knights Templar, the famous order of warrior monks who raised their own revenue and were a power that the Church as much feared for its independence as relied upon for protection. M&A bankers present their profession as High Art, charging large fees for what seems quite modest work. When clients thought my M&A firm's hourly charge outrageously high, I would smile sagely and tell the following story.

A rich man brings a rough diamond to an old jeweler. The old jeweler studies the stone, positions his chisel, and, with a single sharp blow of his hammer, splits the stone with perfect cleavage, yielding four perfect gems. A week later, the rich man receives a bill for \$100,000. Enraged, he calls the old jeweler: "Are you nuts? \$100,000? You didn't work an hour!" "I'm sorry," responds the old jeweler, "I should have itemized my bill: For cutting the diamond, \$10; for knowing where to cut the diamond, \$99,990."

For investment bankers, relationships are key. The inside term is "coverage," which means that bankers are assigned, usually by industry, to particular corporate clients and tasked to "cover" them. Translation? To smother or metaphorically kidnap them if necessary, with the twin goals of eliciting some new fee-generating deal and preventing competing bankers from getting or staying too close.

The fact is that despite all the front-page glory M&A transactions receive, most prove less lucrative than corporate buyers initially expect. This does not mean, of course, that successful acquisitions are not done. They occur all the time: Astute buyers pay high prices, turn their acquisitions into star performers and generate even higher returns. These rare—but not random—occurrences happen when perceptive buyers discern deep, untapped, even unrecognized opportunities, often involving operational leverage.

In the first article of this two-part series ("What M&A Bankers Would Rather I Not Write," July/August), I revealed the kinds of manipulations that investment bankers use to make CEOs pay too much for acquisitions. In this article, I explain the 10 principles by which CEOs can defend themselves against overpaying.

Never Believe M&A Bankers. M&A bankers are not your friends. Not even those on your side, much less those on the other. This does not mean that what they tell you is knowingly false; indeed much of what they say is probably true. Most bankers, most of the time, tell the truth. The problem is twofold. First, what is true may not be the whole truth. Second, you don't know when they're not telling the truth—and sometimes neither do they.

This does not mean that you, as a buyer, should not listen to bankers representing a seller. Listen hard, because the one thing you know for sure is that whatever they tell you is crafted to get you to pay more. You'd be surprised how much you learn when you listen through this filter. For example, if bankers are stressing one thing, say, increasing net profits, why are they neglecting another, say, decreasing gross margins?

Run Your Own Numbers. Never rely on numbers generated by the other side's bankers. You shouldn't even use their models. There is great benefit working de novo: Build your own models; start from first principles.

Speak Directly With the Seller. Try to get time alone with the sellers, without bankers present—yours or theirs. Bankers will not like this. They fear that if buyers and sellers meet privately, this may diminish their perceived value, an unhealthy psychology when it comes time for M&A fees agreed to in principle to actually be paid.

At my firm, we told our bankers never to allow our clients, the sellers, to be alone with the buyers. It was as if our clients were underage juveniles and potential buyers were sexual predators. If such an encounter occurred, we chastised our banker for dereliction of duty. When meeting with bankers, watch when they become nervous, switch subjects or interrupt their clients, the sellers. Each is a lead to follow.

Negotiate With Another Company. Never negotiate with only one target. Try to find another candidate you can explore acquiring as an alternative. Even if this other company is a stretch, there is psychological benefit in diversifying your acquisition explorations. M&A bankers representing sellers seek as many buyers as reasonably possible; it's part of their DNA. In my past life, we indoctrinated our seller clients and prospective clients with the mantra, "One Buyer is No Buyer." Buyers should balance negotiating power by having acquisition options.

Plan a Worst Case Scenario. The best case will take care of itself; the worst case is what CEOs should study. What are all the things that could go wrong with an intended acquisition? Think not only about usual issues, such as integration and operations, but also about unusual shocks, such as product liability and macroeconomic dislocations.

Never assume that the future will mimic the past. There are two reasons for simulating depressing scenarios: It will make your company better able to respond if such circumstances occur; and it will dampen the euphoria that drives up prices—and investment-banking fees.

Seek Anti-Synergies. Most corporate acquisitions are driven by searching for synergies, trying to materialize greater value by integrating the acquired company with the acquiring company for a combined post-acquisition value larger than the sum of the separate preacquisition values. Clever buyers do the opposite. They seek synergies that are imagined but do not really exist, those that appear to be real but when attempted following the acquisition turn out to be illusory. I call these Anti-Synergies; they are the most insidious because you keep trying to make them work.

One way to find these hidden corporate viruses in your pre-acquisition analysis is to assume that each synergy for which you are doing the deal will be defeated. Try to imagine ways in which these apparent synergies disappear and calculate the consequences of each disaster. The exercise will be revelatory.

Scrutinize Any Recasting. Watch for hidden traps when assessing "recasting," or the normalization of revenues and expenses. Here are two: If the recasting substantially reduces owner compensation to supposed market rates, can you really get a first-rate CEO for that lower salary? And check whether all those "one-time" expenses, such as extraordinary legal expenses, that get normalized (i.e., eliminated in the recast) are actually expenditures that regularly occur.

Don't Bid Against Yourself. M&A bankers love this technique. Here's the situation: 1. You are the only viable buyer; 2. the seller is anxious to unload his company; and 3. you keep sweetening the deal. That, we would say, is the fingerprint of a good banker. The antidote? Don't be quick to raise your bid.

Watch Those Who Get Rich. Never assume that any seller who gets rich on your money will stay around post close, or that if they stay that they will work hard, or that if they work hard they will continue to do so. Former owners may have every good intention, but reality sets in quickly. Newly rich people become fickle. Be especially careful when an entrepreneur is selling.

Discern the Difference Between Owners and Managers. There are two kinds of companies that sell: those that are sold by owners who are active managers and those that are sold by managers representing passive owners. This difference colors every aspect of the deal. (There is also a difference between entrepreneurs, the founders of the business and subsequent generations of family owners.)

Entrepreneur owners will do things that professional managers will not. They will react more emotionally, particularly regarding their employees (or certain employees). And you know what? They have earned the right to act that way. They created their company and struggled through hardships. If they now want to do something unusual, work with them.

Finally, good investment bankers do bring a wealth of experience to deals. What's more, because they expect to make a great amount of money and because they are profoundly concerned about their reputations, they will work intensely and creatively to make deals successful. The bottom line? There is nothing wrong with paying high investment banking fees as long as the product you get is a perfect gem.

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