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PERSPECTIVES ON THE CAPITAL MARKETS FALL 2018

INSIGHT

Creating Effective M&A Teams

Balancing risk, returns and professional egos.

by Mark Working & Kapil Sharma

M&A transactions are complex, involving many participants. Selling a business is usually a once-in-a lifetime experience for the business owner, while for the professionals engaged to assist, the process is their job. Experienced transaction advisors (bankers, attorneys, accountants, and others) may have previously worked on numerous deals together. With joint experience, they might have learned how to blend their individual expert services to gain effectiveness. However, it is far more common that the group serving any particular client will not have worked together in the past. This article focuses on this familiar situation, emphasizing the client, the investment banker, and the owner's legal counsel, who are at the core of most private transactions.

FOUR BASIC STAGES

A high-performing M&A team requires each member exceling in their role with an eye towards achieving the client's objective. According to the team development theory proposed by Dr. Bruce Tuckman, a psychology professor, the journey to become a high performing team can be broken into four basic stages: forming, storming, norming and performing.

A high-performing M&A team requires each member exceling in their role with the eye towards achieving the client's objective.

According to Tuckman, during the *Forming* stage of team development, team members are usually excited to be part of the team and are eager about the work ahead. At the start of most M&A engagements, team members have high positive expectations of the outcome and their individual contributions. At the same time, they may also feel some anxiety, wondering how they will fit with the team and if their performance will measure up.

As the team begins to move towards its goals, it enters the *Storming* stage. Members often discover that the team can't live up to all of their early excitement and expectations. There are certain perceived conflicts between the attorney and the investment banker. While the latter is charged with achieving the best economic outcome for the client, the attorney's role is to minimize risk. Their focus may shift from the tasks at hand to feelings of frustration with the deal's progress or the team cohesiveness. Without a history of past experiences, the *Storming* stage can be a period to prove oneself worthy of trust. This is usually the stage with the lowest team effectiveness.

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Establishing a free network of communications at the onset among all parties is a common challenge. Often, it is more comfortable for each professional to communicate directly with their client and rely on them to decide

CREATING THE DEAL TEAM

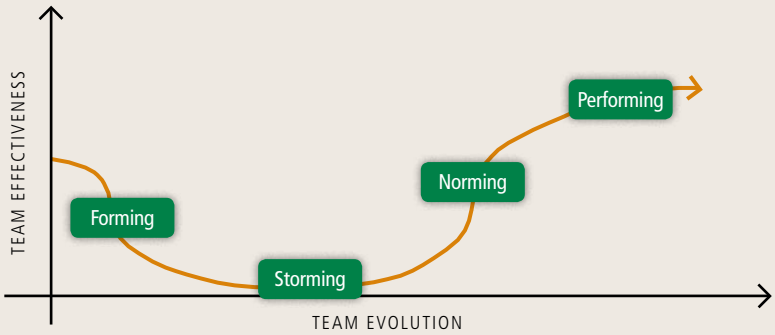
DEFINE ROLES EARLY
Agree on a delineation of roles and responsibilities

COMMUNICATE EFFECTIVELY
Meet in person, or by phone as often as practical

MAINTAIN DEAL MOMENTUM
Have a clear path to closing

PICK YOUR BATTLES WISELY
Some issues are not worth the cost of the fight

TUCKMAN'S TEAM DEVELOPMENT CYCLE



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what and when to pass on to others. We refer to this as the "hub-and-spoke" communications method. It relies on the least experienced person, the client, to be the traffic director of instructions and information flow.

Problems can surface late in the process when deal issues need to be decided and interactions with the opposing team heightens in intensity. Attorneys have an extra level of communications challenge when they bring in subject matter experts (e.g., tax, environmental, employment). Usually, these experts do not have a good sense of the deal dynamics and are asked their opinion on narrow issues. If the lead deal attorney doesn't properly put their responses in context, the answers can slow or stop the deal's progress as non-experts (i.e., client and bankers) try to interpret the implications.

Sending back and forth one side's position with the hope and expectation that the other side will see the obvious wisdom and rationality of the argument rarely is effective.

Unfortunately, some M&A teams do not move beyond the Storming stage. To achieve higher levels of performance, teams need to up their game. During the *Norming* stage of team development, team members begin to resolve the discrepancy they felt between their individual expectations and the reality of the team's experience. Constructive criticism is both possible and welcomed. Members start to truly feel part of the team and can take pleasure from the increased group cohesion. Trust can begin to be earned.

In the final *Performing* stage, members feel attached to the team as something "greater than the sum of its parts" and feel satisfaction in the team's effectiveness. Members genuinely feel confident in their individual abilities and those of their teammates. This leads to the highest levels of team effectiveness.

SOME PRACTICAL SUGGESTIONS FOR CREATING A HIGH-PERFORMING DEAL TEAM

1. Define roles early

Our recommendation in every assignment is that, before starting the process, the members of the deal team meet together with the client and agree on a delineation of roles and responsibilities, a process to keep everyone abreast of the process, and a work style that encourages the different experts to collaborate among themselves. The most effective processes are where the client acts more as a CEO than a COO. They are kept abreast and brought in to decide critical decisions and to approve tactics.

2. Communicate effectively

People do business with people. As we discussed in a previous IN$IGHT article ("The Case for Face-to-Face" IN$IGHT, Fall 2007), the great advances in technology have allowed the speed of data transfer to increase dramatically but with some fallout in terms of actual communication. Our observation:

When working from behind the curtain, it is too easy to avoid hearing or understanding the other's position. Saying "no" in person is harder than by email. It is also difficult to grasp the entire context of someone's comments when there is no opportunity for interactive, real time, probing questions and answers.

The point of interacting with the other side in a transaction is to get resolution to differences or to determine that resolution is not possible. Sending back and forth one side's position with the hope and expectation that the other side will see the obvious wisdom and rationality of the argument rarely is effective. Meet in person, or at least organize a phone call as soon and as often as practical. Include all the relevant members of the team.

3. Maintain deal momentum

Speed is not just for expediency. At the point in a transaction when the parties have agreed to try and get a deal done, there is nothing good that occurs for the seller by time passing. Having a clear path to closing, turning documents, resolving issues quickly, and having consents and approvals lined up are the tasks for the team. There is no standard for what constitutes "quick" but a team that has been working closely together can often turn a purchase and sale agreement back to the other side overnight.

4. Pick your battles wisely

"My document is better than your document," or so some negotiations seem to go. Attorneys have thought hard about the issues involved in M&A transactions and revise their base set of agreements to reflect their most current thinking. Getting it right and minimizing risk is the goal. Yet, the team on the other side has the same set of objectives and often sees the same issue through a different lens. The challenge is to determine where the risks lie and what they really mean in terms of potential outcomes for the client. Some issues are not worth the cost of the fight.

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IT'S NOT EASY

Balancing risk, return and professional egos is not easy. However, when professionals gain joint experiences, they can begin to appreciate each other's skills and have trust that their fellow team members will not fail them or the team. When this happens, advisors can genuinely help their client achieve the best possible deal. **zs**

Analyzing Suppliers From a Transaction Perspective

Identifying potential issues can enhance the prospects of a sale.

by Jay Schembs

Suppliers are the lifeblood of nearly all businesses. Particularly for manufacturers and distributors, unique supplier relationships enable businesses to generate superior returns. In that vein, the loss of an important supplier can have a crippling effect on a business. Michael Porter's "Five Forces" delves deeply into suppliers as an integral component of competitive advantage, and our intent is not to rehash his writing. Instead, this article analyzes supplier relationships within the context of a capital markets transaction – whether that's a sale, minority equity investment, or debt financing. In each instance, the investors' due diligence processes will closely scrutinize supplier composition and relationships. Identifying and addressing potential issues or roadblocks in supplier relationships can greatly improve the outcome of a transaction.

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contractual terms that affect assignment to a new owner, and supplier power. Each of these categories can drive away otherwise interested buyers, derail, or delay the desired transaction.

Although these risks are real, each transaction is unique. For example, a strategic buyer may be seeking an acquisition specifically because of a supplier relationship. In other instances, heavy exposure to one supplier may help reduce an acquirer's reliance on its own supply network. For most private equity buyers, however, there are few circumstances that can turn these dynamics into positives. In fact, some risks are perceived to be so significant that a private equity buyer will not even consider an acquisition, limiting the potential buyer universe. It is prudent for the business owner to recognize these risks and attempt to mitigate the potential negative consequences for the benefit of the business and the transaction.

1. CONCENTRATED SUPPLIER BASE

A concentrated supplier base exposes a business to the conditions and vagaries of the specific supplier. A supplier's own business or financing decisions are often not completely known and that company's financial and liquidity situation could impact its ability to perform. During the Great Recession, Chinese seafood processing businesses became credit constrained and could no longer finance inventory purchases, thereby leaving US retail customers short on expected product, as well as causing Alaska seafood processors issues by interrupting their revenue streams. Suppliers are businesses as well and may have different priorities for different customers. If the business relationship is not important enough for the supplier, the business will be at risk for other supplier customers inserting their own priorities. If the supplier is unable to deliver according to the time and quality standards expected, the business may experience serious problems.

Vetting, training, and negotiating new supplier relationships take time. A buyer will reasonably want to understand the supplier dynamics and the path to mitigating that risk through expanded supplier relationships.

2. NO BACKUP FOR CRITICAL INPUTS

A potentially even greater risk is when the supplier is unique. If because of specific product characteristics (e.g., recipe, patented process, or restricted access to a market), interruption to supply can be lethal, the only solution will be a substitute input that could materially change the nature of the business's cost structure and product profile. This is often a more difficult risk to uncover, since certain "critical" inputs may comprise a negligible portion of a company's costs. Sellers should expect that any strategic or financial buyer is sophisticated enough to identify critical inputs during due diligence. Even if the current owners are willing to live with this risk, it should not be expected that a new owner will feel the same. A backup plan is essential.

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3. ONEROUS CONTRACTS

Contractual arrangements with suppliers are a double-edged sword. On the one hand, they (usually) clearly define the relationship, removing ambiguity as to what is expected or required from the other party. On the other hand, contractually obligating the business to something like minimum purchase volumes reduces flexibility and optionality. Further, many contracts contain change of control provisions that grant a supplier (often a landlord) negotiating leverage at an inopportune time. Many a deal has been delayed by the inability to track down the landlord on a weekend to get his or her consent to satisfy a final closing condition. When negotiating supplier contracts, owners are wise to be cognizant of a contract's potential impact on a future transaction.

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4. UNDUE INFLUENCE OVER TRANSACTION

One of the more obscure but significant risks in certain supplier relationships is the right of first refusal ("ROFR"). Certain industries rely on symbiotic relationships between manufacturers and distributors, where the customer has direct and recurring exposure to both. For example, the auto dealership model exposes customers to both the dealer – with whom they interact for initial sales and often follow-on service and warranty work – and the OEM, whose product they are buying. The OEM worries their brand could be at risk with a dealer unable to effectively service the end customer or who may be inadequately capitalized to respond to the OEM's demands for facility growth and technology upgrades. Because of these concerns, such agreements often contain ROFRs granting the OEM the ability to step into an executed sale agreement, if they are concerned about the new buyer. In some cases, the OEM supplier may require absolute unconditional approval of the buyer or even the right to select the buyer. We have completed numerous transactions in these situations and are well aware of the uncertainty and added time/expense such complications present. In these instances, creating an open dialogue with the OEM such that a seller has a clear understanding of an OEM's expectations can greatly assist in a sale process.

As most owners are painfully aware, supplier relationships are of vital importance to a business. These relationships, cultivated over years or decades, provide access to inputs of products that help a company serve its customer base. Often this access provides differentiating characteristics enabling extraordinary economic returns. While the risks outlined above may seem innocuous on a day-to-day basis to most owners, mitigating them can materially improve the terms and conditions in a debt or equity transaction. **zs**

To Hedge or Not to Hedge

When does it make sense, and what are the alternatives?

by Kapil Sharma & Mark Working

Earlier this year, Derek Kerr, the CFO of American Airlines, explained why he does not hedge fuel costs.[1] At American, fuel represents 20-25% of total costs, second only to payroll. Is Kerr being reckless? Why don't carriers like Alaska and Southwest share his views on fuel hedging? In this article, we will discuss why companies hedge, when it makes the most sense, and what are some alternatives to hedging for managing business volatility.

WHY HEDGE?

Volatility in global commodity and currency markets has been a condition since the beginning of trading and mercantilism. For some perspective, the Dojima Rice Exchange in Japan was the first to trade standardized futures in 1730, with two types of rice markets. In modern times, executives with exposure to underlying input price volatility have a wide range of market options and tools to hedge such exposure. The purpose of hedging is always the

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same – to reduce uncertainty.

Let's go back to American Airlines to understand the cost of hedging. According to Kerr, with oil at $60 a barrel today, the cost to lock-in a cap on prices at $70 for a defined future period would be roughly $10. So, American wouldn't be better off for buying the hedge unless the price of oil during the hedge period averages $80 or more. Kerr's position is that the cost of fuel hedging is currently too high.

Whether American buys or doesn't buy the hedge, by the mere fact that it consumes commodities that have volatile market prices, it is making a commodities bet.

Hedges are not costless, and hedging can't help a business escape the realities of risk-return tradeoffs related to the markets in which it operates. Reduced volatility in the short-term means lower profits for the purpose of avoiding potentially even lower profits. As such, hedging, for the most part, is a technique not by which money is made, but by which potential losses are reduced.

ESTIMATING TRUE FINANCIAL EXPOSURE

With the objective of entering into a commodities hedge to dampen the volatility of profits, sometimes it's easy to get caught up in the perfection of the hedge without recognizing that the hedge may not be directly connected to the company's profits.

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The first issue is the imperfection of the hedge itself. Hedging an index of commodity prices (world oil prices in our example) may not link directly to the cost of a specific input for a given business. Unless the specific input is contracted for at known volumes, there will always be some imprecision to the hedge.

The greater issue is how the business is able to reprice its products or services as its inputs change. Consider oil refineries where crude oil costs are the majority of total costs and where they are able to rapidly pass on most crude price changes to their customers. A perfect hedge in this case may actually increase volatility as it locks in a fixed cost to a variable revenue stream.

WHEN DOES HEDGING MAKE SENSE?

A business can't avoid all risks, particularly those specific to its industry. Businesses make profits by consistently pricing their services and/or products at levels that compensate for these risks.

Hedges are most appropriate when a business is in a situation so precarious that it can't afford the downside potential of market movements, or when assets and liabilities are mismatched. Examples of appropriate hedges in both cases include:

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- A low-margin manufacturer or distributor with customer prices set for an extended period. In that instance, hedging input costs (perhaps through futures or purchase commitments) for the same period makes sense as the business may not be able to survive sustained volatility; or
- A business with a stable margin profile (as a result of stable prices and known costs) with high leverage enters into an interest rate swap to protect against interest rate swings that could erase its profit margin. The capital structure is agnostic to the market dynamics of the business and therefore protecting business value from unrelated market swings until leverage is reduced is a worthy goal.

ALTERNATIVES TO FORMAL HEDGING TOOLS

Besides hedging, businesses can take other actions to address profit volatility and commodity risks. Examples include:

- Holding greater cash reserves to fund the down cycle.
- Shutting plants when input costs become unsustainable.
- Vertical integration. Going back to our airline example, in 2012 Delta Airlines made a controversial move to acquire an idled oil refinery in Trainer, Pennsylvania.
- Passing on currency risk to suppliers and/or customers by contracting only in U.S. dollars. This is a complicated issue as the underlying risks may not go away and to think that assigning risk to a supplier or customer will have no impact on your revenue or cost stream might be perilous.

Any business operating in a market where certain costs or revenues are subject to market movements, not directly controlled by the business, can't escape the volatility it implies. Given enough time, a business in that market will suffer during some periods and gain windfalls during others.

Entering into hedges reduces overall long-term profits. But, as Maynard Keynes famously quoted, "In the long run, we're all dead." Choosing how and when to use hedging tools largely depends on a company's specific situation, the company's ability to weather cycles, and the owner's risk appetite. Since no one can reliably predict commodity, currency, or interest rate movements, the impact of any particular hedge is likely to be random. The only given is the collective costs of all hedges. Over time, in exchange for reducing business volatility, these costs will also reduce profits. **zs**

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[1] *https://soundcloud.com/american-airlines-internal-news/07-feb-28-2018-were-better-off-letting-the-fluctuations-of-fuel-happen-derek-kerr*

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to **ZacharyScott.com.**

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