Chapter 6

**EQUITY MARKETS:**

**IPO & Precedent Transaction Process & Analysis**

This chapter will cover in detail the last stage of a company’s maturity and development – an Initial Public Offering (IPO). Once the company becomes public, the chapter will then describe the precedent of an M&A transaction and the Tender Offer procedures involved, starting from the bidding stage to close and funding stage. The analytical approach for valuing the company in order to raise capital will be described in more detail in chapters 9 and 17. This chapter gives an introduction to the process of raising capital with which the reader should follow-up with a valuation analysis of pricing the company for M&A and M&A accretion/dilution as well as going from public to private via a Leveraged Buyout (LBO) and Recapitalization financing.

Learning Objectives

After reading this chapter, students will be able to**:**

* Briefly understand the life cycle of a public company
* Understand how a company raises capital at various phases of its growth and development.
* Understand the process of an Initial Public Offering (IPO), Follow-On Offerings and Rights Offerings.
* Apply various analytical tools as an investment advisor to determine the best course of raising capital.
* Understand how transactions are financed including Mergers & Acquisitions (M&A), Takeovers, Tender offers (TO) and Leveraged Buyouts (LBOs)

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***AUTHOR’S NOTES:***

*Companies that are interviewing various investment bankers advising them how to access the market and how much capital they should raise will conduct a “Beauty Contest” or “Bake Off”. As futile as these cliché terms may sound, they are actually the best analogies for describing the environment Investment Bankers find themselves in. When participating in a beauty contest or bake off, investment bankers will do their best to show why they are the most qualified to lead the transaction.  Their pitch includes the profiles of people on the team and why they are the best option among their compatriots; they will display their “tombstone” of transactions showing their successful track record; they will promote their industry team and how knowledgeable they are; they will show how active their trading platform is; and will focus specifically on providing the most attractive* [*valuation analysis*](http://courses.corporatefinanceinstitute.com/collections) *of the company. I lived through this process and always smile about how much preparation each investment banker goes through to show their best during these periods. There is an old investment banker joke that goes like this: “An investment banker dies and goes to the “waiting room” to find out if he will end up in heaven or hell. St. Peter was buffaloed that he was the first investment banker on the “Heaven” list and gives him a choice. St. Peter tells him to spend one night in hell and one night in heaven and then report back with a decision on where he wants to spend the rest of the afterlife. Curiously, the Investment banker takes the elevator down to hell to see what it’s like. The elevator opens and to his surprise he sees all his colleagues that died before him hanging out at the bar and having a great time. Food and drinks were flowing, there was high level entertainment and a display in the corner scattered with planned golf games for the morning. The next day the banker took the elevator going up to Heaven. As the elevator opened, he walked into a well-lit library with wall to wall books, yoga mats and a harper playing music – people were meditating and reading books – a very quiet place. After experiencing each place, he obviously decides to go to hell as he longs to have fun with his friends and colleagues. St. Peter scripted the contract; the man signed the agreement and he jumped on the first elevator down to hell. When the elevator opened, the room was cold and dark with no one in sight. As he crept into the next room, he saw his friends kneeling and cleaning the floors with water and soap while others were digging holes outside. He approached one of his colleagues and asked what was going on. He said: “I don’t get it. Only yesterday we were having so much fun and today this?” His friend leaned over to him and whispered: “Yesterday, you were a prospect. Today, you are a client”. I always visualize the capital markets as a place where the bankers seeking business put on their best behavior to entice clients to sign with them partly for the best execution and partly to show they are the best. I felt the pressure of putting on a show - I spent hours on preparation. While this is a known solicitation process for business, the investment bankers are often expected to provide a view on the likelihood of success for a particular transaction. On one end investment bankers are pressured to entice the client for more business, but at the same time they must be careful not to guarantee or otherwise make any binding commitments regarding the pricing, deal size or the successful completion of the transaction. An investment banking pitch generally includes a book with which the banker uses to give a visible description of the transaction to the client. From a compliance perspective, bankers should use a basic pitch style template, and have it reviewed by legal or tax professionals. They should never disclose any confidential information on other clients or transactions. Any estimates of transaction fees and expenses should be clearly identified as “estimates” and the valuation analysis should be unbiased.*

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***KEY TAKEAWAYS:***

* *The company’s cash flow and corporate structure determines the types of financing needed.*
* *The companies that are in the market for raising equity need to understand that fundamentals are more important than technicals. Having a good product, good management and feasibility in their future is more important than financial engineering and taking advantage of the over enthusiastic markets.*
* *Valuations are very subjective given all the methods to derive them but at the end of the day, the actual value of the company is the price that someone is willing to pay for it.*
* *Different cycles in the market or the economy can help or hinder access to equity financing.*
* *The Securities and Exchange Commission (SEC) is in place to make sure that any publicly traded companies that are in the market to raise capital go through a rigorous process to protect the investor.*

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The Life Cycle of the Public Company

**Initial Public Offering**

A company will seek equity financing from the public markets through a process called an Initial Public Offering (IPO). When the company is IPO ready (discussed below), they will choose to offer their equity to a large market of investors to meet the existing owner’s following objectives:

* To provide liquidity for the founders and early private investors to sell their holdings to the public markets.
* To establish a broad-based valuation of the company by offering the stock to a large group of investors, hence increasing the existing value to the current owners that stay post-IPO.
* To fund the company’s ongoing needs and access follow-on financings.
* To create stock that can be used to offer executives and employees retirement plans.

Figure 6.1 below summarizes who these IPO investors are, the purpose of investment for the public investor and what the owners need in order to obtain such investment (The IPO process is discussed in more detailed later this chapter):

**Insert Figure 6.1**



The institutional and public investors investing in a new company during and post IPO are looking to enhance their returns through earnings growth and multiple expansion. If this becomes a reality, the broader market will gain confidence and drive the stock price up. It will also continue to increase in the future if expectations for these higher multiples of earnings (PE or EBITDA) are realized. Dividends can also be a source of income for these investors, though typically new IPO companies are still in a growth stage of their development and do not pay dividends.

**Raising Common Stock in the Public Markets (Primary Market) and Post-IPO shareholder rights and trading (Secondary Market)**

Common stock is the most widely held equity security. Investors receive stock certificates that represent the company’s ownership. The state that the company is incorporated in needs to approve the number of shares that will be issued, known as authorized stock or capital stock. These shares are referred to as outstanding shares once they are in the hands of the investors. If the company decides to buy back shares from the public, these shares that are purchased are called treasury shares and are valued and accounted for as a negative number on their balance sheet. When calculating the company’s enterprise value these treasury shares are not included in the calculation.

The investors that buy these shares have the following rights:

* **Voting Rights**: Holders of common stock exercise control by electing the board of directors that vote on corporate policy. Each share gives the shareholder a share of the vote that represents their percentage of ownership as a percentage of total shares outstanding. The voting can be carried out by either a Statutory voting method or Cumulative voting method. The Statutory voting method is based on the stocks that the shareholders owns – one share = one vote. The Cumulative voting method is based on allocating the shares that the shareholder owns to each candidate.
* **Financial Reporting and Company Information**: Shareholders have the right to access certain financial information regarding the company including audited annual reports and quarterly financial statements
* **Dividends**: There are two ways that a shareholder can profit from buying stock: Capital gain which is buying the stock at one price and selling it for a higher price with the difference resulting as the return or by receiving dividends. Shareholders always have the right to receive dividends when the company decides to pay them, something that is not always a guarantee. Companies are free to decide whether to payout their cash flow as dividends or to reinvest part or all the sum into the business. This is a decision that is at the discretion of the board of directors who will weigh future growth possibilities of the company and the capital requirements needed to achieve them. Companies, especially growth companies, may decide not to pay dividends and instead reinvest the profits to grow the company resulting in a higher pay off in the future.
* **Pre-emptive Rights:** When a company decides to raise additional common stock, the existing shareholders are occasionally given pre-emptive rights or the right to buy newly issued stock before the shares are sold to the public. This is mainly to give current shareholders the option to keep the same percentage of ownership – basically to prevent dilution. These rights are not common in the US markets but are seen more in younger companies that are still in their growth stages.

**Dividend Payment Process:**

The process of dividend payment is outlined by understanding a congregation of important dates:

1. **Declaration Date**: This is the date by which the board of directors declares dividends. In their announcement they mention two other dates including the record date and the payable date.
2. **Record Date**: This is the date where which the shareholder must register on or before that date to receive the dividend.
3. **Payable Date**: This is the date that the dividend is paid to the shareholder on record.
4. **Ex-Dividend Date**: This is the date 2 business days prior to the record date. Any regular way trades of the stock take 3 days to settle (T+3) which will give the official title of the stock. The ex-dividend date is the first date where a buyer can purchase the stock without receiving the dividend. Figure 6.2 gives an illustration of who receives it and when the dividend is paid.

**Insert Figure 6.2**



**Stock Splits**

A stock split occurs when a company believes the price per share is too high to keep buyers interested in purchasing shares. This of course is due to the perception that the market of buyers shrinks once the stock price is too high, as the common unsophisticated investor looks for other cheaper stocks to purchase instead. For example, a 2-for-1 split of a stock that is trading at $50 will result in the stock trading at $25 ($50/2). Note that holders of the stock will double their shares at the time of the split, preventing dilution of current investors. A reverse split is when the stock price is too low, and the company decides to reduce the number of overall shares to increase the per unit price. For this to occur it usually indicates that current perception of the stock is weak, growing weaker, and the low per share price is contributing to that perception. For example, in a 1-for-5 reverse split, five $5 shares become one $25 share (5x$5).

**Classifying Common Stock**

Stocks are classified based on investment characteristics as follows:

* **Income Stocks:** These are stocks of companies that consistently pay dividends. When an investor purchases income stock he or she expects to receive dividends. Most of the return for such an investment is based on consistent dividends. Companies that are classified as having income stock are more mature companies with limited research and development and stable cash flows. There are two methods of calculating the dividend payout ratio:

$$Dividend Payout Ratio = \frac{Annual Dividend}{Net Income}$$

and per share,

$$Dividend Payout Ratio = \frac{Annual Dividend per share}{Earnings per share (EPS)}$$

The dividend yield (δ) % per share is calculated as follows:

$$Dividend Yield \left(δ\right)\% = \frac{Annual Dividend per share}{Stock Price}$$

**Growth Stocks:** These are stocks of companies that reinvest most of their income into their business. Investors buying these stocks expect a higher capital gain from growth in share price due to expanding earnings/revenue multiples. These stocks also commonly trade at higher multiples or price to earnings ratios (P/E). Since the expectation is for the company to grow, the stock is very sensitive if the expected growth (mainly quarterly/yearly earnings targets) is not met. This generally causes the stock to drop even if the profit grows incrementally year over year. Expectations and the potential to meet earnings and revenue targets are key when valuing growth stocks and their potential for capital gain. For tax purposes, note that investors pays less taxes on realized capital gain than on dividend income.

**Stock Prices and Investment Opportunities: Growth Stock Vs Dividend Stock**

Let’s assume that two companies, Cash-Is-King, Inc. (“CIK”) and Growth-Is-The-Only-Way, Inc (“GITOW”), each have an expected net income of $10 per share. In principal, both companies could pay out all the income they’ve made to the current shareholders as dividends. If the Capitalization Rate (κ) is 10% (a valuation method discussed in later chapters), both companies would then be valued at D1/κ = $10/10% = $100 per share. If all the profit was distributed to the shareholders instead of reinvested in the company, the company is not anticipated to grow.

Now suppose rather than paying it out as dividends, GITOW reinvests the profit into a project that generates 15% return on investment. You will notice this is greater than the capitalization rate (κ) of 10%. If that is the case, it would then not make sense to pay all the profit to the shareholders in the form of dividends. Given the good prospects of the project that should return 15%, GITOW decides to pay a much lower dividend in order to reinvest the other portion of the prior year’s profit into the project - let’s assume they pay out 50% of the profit instead of 100% of the profit - this is called the **Payout Ratio**. The maintaining of the other 50% is called the **Plowback Ratio.** In this case, GITOW will only pay $5 in dividends ($5/$10=50%) and reinvest the difference of $5 per share into the project that is expected to generate 15% return.

Suppose GITOW’s project costs $100 million and is entirely equity financed. Thus, with an expected return on investment of 15%, it will generate $15 million of income (15% x $100 million). Let’s assume there are 3 million shares outstanding at $5.00 per share ($15 million / 3 million shares) which would be all of the equity capital invested in the business (there is no debt). If 50% of the project’s $15 million profit is reinvested, then the value of the company’s stock should increase $7.5 million (50% x $15 million) or 7.5% ($7.5 million / $100 million project). With the 7.5% higher invested capital, the company yields 7.5% more income and ultimately will pay a 7.5% higher dividend. This is due to the increase in price being that dividend payouts are expressed as a percentage of each shares current value (dividend yield). The 7.5% represents the company’s growth rate on the underlying profit and thus the value of the stock will go up. Using the intrinsic value method (discussed in chapter 17) we value the new stock as follows:

Price = $\frac{D paid}{κ-g}= \frac{\$5}{.10-.075 }=\$200$

Notice $200 is twice the value of the $100 current value of CIK’s stock with 100% paid dividends and no growth (Price = $\frac{D paid}{κ-g}= \frac{\$10}{.10-0 }=\$100$).

It’s important to note that the calculated $200 value of the stock for GITOW is based on an expectation that the company will return 15% on the project. The stock will be trading near $200 as the expectation is 100% that the project will be a success. If the realized return of the project is lower, then the stock will drop. The additional $100 ($200 value for GITOW - $100 value for CIK) is called Present Value of Growth Opportunities (PVGO).

**Private Placements and Private Investment in Public Equity (PIPEs)**

Another way of raising capital is through private placement. The company issues shares to accredited investors (instead of the public) under the Securities Exchange Commission’s Regulation D. Private placements may be offered to an unlimited number of investors as long as they are accredited. The company prepares a Private Placement Memorandum (PPM) which includes a) the structure of the deal; b) brief information about the issuer; c) the issuer’s management; d) 2-3 years financial statements; e) risks and other disclosures; f) use of proceeds and g) the subscription agreement and sales contract. Private Placement will be more thoroughly discussed in the next chapter (Chapter 6).

Syndication of Securities Offerings

**Initial Public Offering (IPO)**

An IPO is the company’s first public sale of securities - basically a privately-owned company is going public to raise capital primarily to either fund operations and/or payout the existing owners. The IPO itself is a registered filing with the SEC, offering the sale of the company’s stock to public investors. It involves choosing an investment advisor and underwriters to first determine the offering price and then secure potential investors. The success of an IPO is mainly dependent on favorable market conditions. The company also needs to have all the characteristics of an IPO including visibility of stable cash flows, a high probability of growth, and a demonstration of niche industry characteristics. Typically, the process takes 3-6 months depending on the condition of the market and size of the IPO.

**STEP I: Select the Investment Company/ Underwriter**

The first step for a company in the IPO process is to choose an [investment bank](https://www.wisegeek.com/what-is-an-investment-company.htm) that is willing to underwrite the IPO. Before the IPO process officially starts, the underwriter will ask for a [Letter of Intent](https://www.wisegeek.com/what-is-a-letter-of-intent.htm) (LOI) in order to have an understanding that the process will definitely come underway. This is because the underwriter will usually incur a set of initial expenses. This agreement will typically at a minimum offer reimbursement for these expenses in case the company changes its mind with regards to registering for an IPO. Furthermore, the LOI binds the company to being cooperative in the disclosing of all requested financial information during the IPO process. The underwriter will agree to act as diligently as possible in completing the registration and the selling and distribution of the company’s [shares](https://www.wisegeek.com/what-are-shares.htm). The u[nderwriting](https://www.wisegeek.com/what-is-underwriting.htm) fees are also included in the LOI.

**STEP II: Preparing the Documents for the IPO**

The next step in the IPO process involves preparing all the necessary information including financial statements that will be disclosed for official registration. The Securities Exchange Commission (SEC) has a very specific criteria for filing. The SEC’s duty is to make sure that the company adequately informs the prospective investors about the financial performance of the firm and the risk factors present. This document that includes all the information the SEC requires is referred to as the preliminary prospectus or the Red Hearings.

**STEP III: SEC Registration & Approval**

After the preliminary prospectus is filed with the SEC, the SEC makes an announcement that the registration is effective. The SEC will then continue to work with the underwriter to gain additional supplemental information and make the necessary corrections in order for the registration to be approved.

**STEP IV: Marketing the IPO**

After official approval to solicit interest from the syndicate of investors, the next step in the IPO process involves marketing the shares and expectedly the company to these prospective investors. The marketing involves presentations and various pitches that are sent to large scale investors such as financial institutions and corporations.

**STEP V: Indication of Interest**

Based on supply and demand the underwriter determines a market price for the IPO stock, the number of initial shares being offered, and the date open trading will begin. Additional details including the number of initial institutional investors, any price discounts, and modified market prices are filed as an amendment to the original registration.

**STEP VI: Closing, Funding and Free to Trade**

The underwriter then announces the price and determines that the trade process has been established. It takes approximately three days (T+3) for the IPO exchange to close. The stock is then delivered, and the company receives the proceeds (net of underwriting fees) from its sale. The underwriter’s obligation is to monitor the stock's price for a few months post-IPO and exercises the right to purchase or sell shares to make sure the stock stabilizes.

**Types of Underwriting Commitments**

There are two types of underwriting commitments related to the stock in an IPO: Firm Commitment and Best Effort Commitment.

 **Firm Commitment**

**A firm commitment is a commitment from the underwriters** **that enables them to purchase all the shares that are offered in an IPO.** The lead underwriter (referred to as “left lead” or “book-runner”) is responsible to sell, through the syndicate (the other committed underwriters), all the shares to interested institutional and retail investors. If there is not enough demand to sell all the shares after the price is set, any unsold shares are to be distributed among the syndicate. Sometimes the agreement between the company and the underwriters includes provisions for additional shares that will be issued post-IPO. These shares could have pre-emptive rights. In this arrangement, the stocks that are offered as an addition are offered first to current shareholders two to three weeks prior to being offered to the public. This process is called a rights offering. These shares are first offered to existing shareholders, then to the retail investors, and if there are still remaining shares the syndicate purchases them – refer to **Standby Commitments**.

**Best Effort Commitment**

**A best-efforts underwriting agreement is an agreement in which** **the underwriters seek to sell all the shares to the interested investors but have no obligation to purchase any unsold shares**. Typically, this agreement is for higher risk issuers or tough IPO markets as the underwriters do not want to take any market risk. Some best efforts agreements are set as “all-or-none”. This refers to a best effort attempt to sell the shares. If they are short (undersubscribed) of selling 100% of the shares, the offering is cancelled within a specific timeframe – i.e. the IPO is postponed or cancelled.

**Choosing an Underwriter (s)**

For choosing the left lead underwriter or co-underwriters, the company will contact many investment bankers and ask them to give their proposal for a successful IPO offering. The company, in this case the issuer, will decide between the left lead underwriter and other underwriters on who leads the offering. This is largely based on who they feel will provide a successful execution and stable process. For an IPO, typically, the competing process (called a “bake-off) for choosing the left-lead underwriter is through a negotiation process involving all the interested underwriters. Part of the underwriting agreement between the underwriter (s) – in a firm agreement – is the ability to purchase the shares from the issuer and sell them to the public at the offering price. The purchase of the shares from the issuer will run at a discount to the public offering price, representing the underwriter’s fees referred to as an Underwriter’s Spread.

**Underwriting Spread (Fees)**: The components of the spread include three types of fees: Manager’s Fee, the Underwriting Fee and a Selling Concession Fee. The **Manager’s Fee** is the fee that the left lead or the manager of the syndicate receives first. The **Underwriting Fee** is the fee that the syndicate of underwriters receives. The **Selling Concession** is the fee that the managing underwriter, the syndicate members and the selling group receive based on the shares sold. Figure 6.3 below shows the components of the underwriting spread

**Insert Figure 6.3**



**Breaking down Underwriting Compensation**: For small companies, a typical underwriting spread fee is around 12% or discount rate of 88% of the IPO proceeds raised from the offering. Figure 5.9 below shows an example of a Celerity Technology Inc. IPO and the allocation of the spread compensation to the manager, the syndicate and the selling groups:

**Insert Figure 6.4**



**Building the Book**

The first responsibility of the left lead manager is to pre-market the offering to institutional investors (qualified investors). The other underwriters in the syndicate also start pre-marketing to their own investors. Before they start this process called building the book, each underwriter of the Syndicate is allocated shares by the left lead manager. The Celerity Technology IPO example above (Figure 5.9) shows that the company or the issuer is planning to issue 15 million shares. The left lead manager keeps 9 million of the shares and the remaining 6 million are allocated pro-rata (equally) among the three underwriters. These institutional investors that are interested in purchasing the stock will give an indication of interest (IOI). These IOIs will become orders on the effective day, though they are not obliged at this point to commit and are able to cancel any time before purchase. The syndicate and other institutional investors are motivated to be part of the selling group so they can accumulate fees. Therefore, in the marketing stage, the involved investment banks are calling/presenting to groups of high-quality investors to get either verbal or written IOIs. Much larger investors will ask to meet management and view their presentations.

**The Building-the-Book stage is probably one of the most important stages during the offering as the manager, syndicate, and selling group receive a lot of market feedback and evaluate the demand which can be** **used as the basis to start the discussion on the offering price.** The initial discussion on the offering price is usually a range. Using Celerity Technology’s IPO example above (Figure 5.9) before it settled at $40, the range could have been $38-42. This range is not binding and the discussion with the investors during this period is to close in the range based on strong or weak demand. If there is a strong demand at a certain price the underwriters may decide to increase the number of shares. Once all the investor demand is accounted for based on the range, the underwriters work with the syndicate and the selling group to allocate or “circle” shares. Technically, investors can change their minds and get out of their circle, but this practice is discouraged as it would be a devastating business blunder for the investor in case of future business with the syndicate group.

**Setting up the investor list by Underwriter (Allotment)**

Before the Building-the-Book stage which involves the pre-marketing of the offering, the list of investors could be allocated among the underwriters. This process, which is the preferred process in the US, is called a **Fixed Pot Arrangement.** This arrangement is sometimes cleaner to execute since each underwriter focuses on their allocated list of investors and fees are shared across all despite one underwriter doing better than the other. The **“Jump-Ball’ Arrangement,** is basically an arrangement that the credit of circling investors are on a first-come-first-serve basis and the underwriters are paid based on how big a book they are building with IOIs.

**Pricing**

The left lead manager is untimely responsible for letting the issuer know about the success or failure of the book building effort and the state of the market including records of other IPOs that have already been priced. **The manager also confirms the final pricing and scheduling**. After looking at the final book with all the orders at different prices within the range, the manager sets the price and communicates it to the company. In the Celerity Technology IPO example, (Figure 5.9) the final price is $40. Given that the total issuance represents 15 million shares and the total capital raised is calculated to be $600 million. After subtracting the gross fees totaling 6% of the total capital raised or $36 million are allocated, the net proceeds to the company is estimated to be $564 million before any other transaction expenses.

**Other IPO Terms, Concepts, and Conditions**

**Over-Allotment Option (“Greenshoe”)**

Many underwriting agreements may include a provision that the underwriter can exercise the option to issue more shares than originally anticipated. This provision is called “Greenshoe” and is usually used when the orders from investors are higher than the original number of shares scheduled to be issued. The Over-Allotment option is known as a Greenshoe named after the Green Shoe Manufacturing Company was the first to issue this type of option some time ago. This is used to provide some price stability and helps balance volume and price when it is free to trade in the secondary exchange market. This option typically allows the underwriters to create and sell more shares (maximum allowed 15%). The actual percentage and terms are included in the prospectus that is filed with the SEC prior to the offering.

The decision to use the Greenshoe option is dependent on the market demand for the offering. If the IPO is a success and stock price increases after the IPO is priced, the underwriters can buy extra stock from the company at the IPO price and sell it in the market to record a profit. On the other hand, if the prices post-IPO closing decreases, they buy back from the market at a lower price to support their short position and support the price of the stock. Most issuers don’t like this option in the agreement especially if the proceeds of the IPO are used for a special project with a defined purpose.

**Lock-Up Agreements**

Since one of the underwriters’ responsibilities is to stabilize the stock after the IPO is priced, the underwriters generally require the management of the issuer and large shareholders to enter into a lock-up agreement. This agreement is meant to avoid a group of insiders such as management and large holders of stock to dump the stock after the IPO is priced and cause a steep price decline. The lock-up period is typically set at 180 days. This should be enough time to allow the stock to stabilize after the IPO.

Merger & Acquisition Transaction

**Steps for the Transaction Analysis**

Prior to any transaction such as an Initial Public Offering, Merger & Acquisition or restructuring, the investment banker that was hired to assist with such transaction needs to conduct a preliminary analysis to determine the offering price range. This analysis involves multiple methods to derive a price range including trading comparable analysis, acquisition comparable analysis, and the discount cash flow method. Chapter 17 goes into an in-depth discussion on these and other methods that are used to value the company. The following shows the step-by-step approach to executing such pre-pricing transaction analysis.

**STEP I: Select Comparable Acquisitions**

The Investment banker’s job is first to identify the universe of comparable companies to be used for trading comps. This is always very challenging. The investment banker finds him/herself justifying ways that these companies are truly comparable to the target and its sector. The banker first searches their own database to see if a relevant set of comparable acquisitions exists. He or she then searches various M&A databases, merger proxies of comparable companies that include fairness opinions. It’s important for the banker to learn as much as possible regarding the target company and all the circumstances surrounding the transaction.

**STEP II: Find the Necessary Financial Information Related to the Transaction**

Once the peer or comparable companies are identified, the banker gathers as much information as possible for these companies including financial statements, related acquisitions and press releases. Since the analysis needs to be publicly disclosed to justify the fairness opinion, its important to note that the banker only discloses information that is publicly available. When using an M&A database that includes private companies, it is very difficult to obtain or disclose the information if available.

**STEP III: Review Key Multiples for Trading and Transaction Multiples**

Once all the relevant information is screened and agreed upon internally that these publicly traded companies are truly comparable to the target, the banker then spreads all the information of these companies and determines the multiples ratios such as Enterprise Value to EBITDA, Enterprise Value to Revenue or even Enterprise Value to Net Income. Figure 6.5 below shows a comprehensive trading comparable analysis in the hotel sector.

**Insert Figure 6.5**



The next set of comparable analysis is to compare the target company to other acquisition related transactions. For each comparable company, the banker writes a brief description of the acquisition that occurred and why it is relevant to the target company. Figure 6.6 below shows recent acquisitions of hotel companies.

**Insert Figure 6.6**



**STEP IV: Comparable and Benchmark Analysis**

After the trading and acquisition comparable analytical methods are done and justified as truly comparable, the banker sets the average or the range of multiples that are used to value the target company. The average or range of multiples are used as an industry benchmark and the basis for analyzing the target company.

**STEP V: Determine Valuation**

The mean (averages) and median multiples for both analytical approaches are used to value the relevant target company. Figures 5.8 and 5.9 show that the averages of the hotels sector for trading comparable and acquisition comparable are 14.6x and 14.3x EBITDA multiples respectively. These multiples ranging from 14-15x EBITDA will then be used to calculate the relevant hotel company that is either an IPO or M&A candidate.

**Mergers & Acquisitions**

The sale of a company, division, or business is a major event for its owners. It is an intense process with very high stakes. The seller spends time with their banker (sell-side advisor) examining various strategic alternatives including selling all or part of the company, an initial public offering or doing nothing. Once the decision is made to sell, the bankers seeks to achieve the perfect balance between high valuation and speedy execution. The banker’s responsibility is to identify the process that suits the seller’s priorities. They could run a ***broad auction*** which is used to reach out to as many potential interested parties as possible, go to ***targeted buyers*** or zero in on a specific buyer for a ***negotiated sale.*** From an analysis point of view, the sell-side assignment requires the team to run a comprehensive valuation of the target using the various methodologies that were discussed earlier in this chapter and more expansively in Chapter 17. The team also needs to run various scenarios depending on who the buyers are including a private equity firm or another strategic entity. These valuations are used to establish the seller’s price expectation which should be in line with the buyer’s expectations. Chapter 19 will run various valuation scenarios based on buyer expectation including an accretion/dilution analysis for publicly traded companies that buy other publicly traded companies.

The following outlines the process laid out by the Securities and Exchange Commission (SEC) of selling a publicly traded company:

**FIRST ROUND**

**Reaching out to Prospective Buyers**: The banker contacts prospective buyers which marks the official launch of the auction process. The sell-side banker will contact their network of investors with an accompanied one to two-page teaser and the Confidentiality Agreement (CA).

**Execute the Confidentiality Agreement (CA):** The CA is distributed to interested parties’ legal counsel for their review. After going back and forth on comments and negotiations, the CA is then executed. Following the execution of the CA, the sell-side banker is allowed to distribute the Confidential Information Memorandum (CIM) and a letter outlining the bidding process **(Initial Bid Procedures Letter).**

**Distribution of CIM and Initial Bid Procedures Letter:** Once the buyers receive the CIM, typically they have three to four weeks to review it before submitting their initial non-binding bid. Their review includes an analysis of the target and the industry sector that they are in. The buyer’s team of analysts will also run a financial analysis focusing on their historical performance and lay out the other investment opportunities available to them. During this period, the sell-side banker is in constant communication with the prospective buyers to provide additional supporting information. Sometimes buyers, especially buyers that are very interested, will hire their own advisors (buy-side advisors) to assist them with the process primarily with the valuations and how to access financing.

**INITIAL BID**

The Initial Bid Procedures Letter includes the deadline for the buyers to submit their non-binding bid. **The letter also outlines the information that the buyers need to submit with their bid including their initial purchase price and the composition of payment such as all cash, stock, or a combination of the two.** They typically are also asked to show how they derived their bid price. The information provided should also include the structure (Transaction Sources & Uses). The Transaction Sources & Uses shows how the target company will be purchased: Debt and/or equity. Other information needed by the sell-side company are the buyer’s business plan including the treatment of the management and employees, timing of completing the transaction and additional diligence that needs to be performed. A timing sheet will also document other required approvals and timing of due diligence before the final bid is presented.

**Preparation of Management Presentation**: During this period, the sell-side management prepares a presentation – typically a PowerPoint slide show – outlining specific points of emphasis. Included are the a) executive summary, b) industry overview, c) Company Overview, d) Operations Overview, and e) financial Overview. This presentation is in line with the CIM provided earlier, but this time the management presents it in person or via conference call among their business associates.

**Setting up the Data Room:** The company will start to organize and set up the data room for buyers that will be granted during the second round of bids. This is a hub for the buyers to access detailed data on the operations of the company.

**Receive Initial Bids:** The sell-side banker receives the initial indications of interest accompanied by all the information that was stated in the Initial Bid Procedures Letter. Following the initial bids, the sell-side banker and the company will review all the bids received and their indicative purchase prices. The analysis will also include a discussion by the buyers that indicates how serious they are despite their initial bidding price. Once the analysis is completed, the company makes the final decision which includes two or three buyers that proceed to the next round.

**SECOND ROUND**

The sell-side banker will send a letter to the few investors that are chosen to proceed to the second round. The letter will include a detailed timeframe including when the final bids need to be in. It could also include a calendar showing when the investors will attend the management presentations and visit the site facility. Finally, it will have detailed information on how to gain access to the data room on further occasions.

**Management Presentations and Site Visit**: This is the official start of the second round. Management gets a chance to present the company’s operations, business strategy, industry information and financial performance. The presentations, usually given by the CEO and CFOs are followed by a Q&A session. The prospective buyers might bring their buy-side advisors and industry consultants to help them get a comprehensive outlook of the company in preparation for their final bid. Following the management presentation, the company will arrange site visits. These visits provide a firsthand view of the company’s operations – an essential component of the buyer’s due diligence. The scheduled tour of the facilities is generally led by the local manager. Given the sensitivity and confidentiality of buying the company, the investors do not reveal the purpose of their visit.

**Data Room:** In addition to listening to management presentations and visiting the facilities, the company provides access to the data room. The data room includes detailed information on the company, including operational and manufacturing activity data, tax and accounting information, information technology, various tests and environmental inspections and permits. The sell-side banker coordinates all the questions or additional requests from these investors.

**Final Bid Procedure Letter:** Like the initial bid procedures letter in the first round, the final bid procedures letter includes the exact date and details for submitting a final bid. Unlike the initial bid, the final bid is legally binding. The details on the final bid procedures letter includes the purchase price and the method of paying (cash and/or stock), evidence of committed financing and who is financing (banks, financial institutions and equity investors). In addition to the final bid procedures letter, a draft of the definitive agreement is distributed for review and ultimately expected for the buyer to sign. The letter will also include the timing and procedures after the final bid is granted by the buyer.

**Definitive Agreement:** The definitive agreement, once signed, binds both the buyer(s) and seller to agreement of the purchase and sale of the company, respectively. Prior to the seller signing it, a draft of this agreement is sent to the final bidders towards the end of the due diligence process. The definitive agreement includes the transaction structure, representations and warranties, financing commitment and the terms and conditions of the financing.

**Final Bid:** At the conclusion of the second round, the prospective buyers submit their bid to the sell-side banker. These are expected to be the final bid with minimal conditions or “outs”.

**NEGOTIATIONS**

**Evaluating Final Bids**: The sell-side banker works with the company and legal counsel to review the conditions and potential outcomes of all the final bids including the price, structure, terms and conditions. All these are important elements to making the final decision. For example, even if one bid price is higher than the others, the financing structure could be weak, or the terms and conditions could be prudish. Once the assessment is completed, the company selects the preferred buyer or buyers with whom to negotiate a definitive agreement.

**Negotiate with the selected buyer:** The sell-side banker communicates to the buyer that they are among the preferred bidders and needs to clarify a few terms that are included in the final bid letter. During these final negotiations, the banker makes sure that there are not any outstanding issues or requests that are subject to preventing the execution of the definitive agreement.

**Select Winning Bidder:** After the last round of negotiation with the winning bidder, the deal is presented to the company’s board of directors for approval. The seller still reserves the right to reject the bid – basically becoming subject to further approvals. The buyer has some rights of withdrawing from the process, it is rare, though it has happened in the past – this commonly is referred to as a “busted deal”. In a busted deal, expect legal action by the buyer.

**Board of Directors Approval:** For publicly traded companies the board of directors will ask for a fairness opinion on the valuation of the target company. This will be used comparatively with the offer price and could possibly become a reason to negotiate further about the proposed offer. The fairness opinion is a letter commenting on the overall “fairness” of the offer that is under consideration. It includes various valuation methods including comparable trading and acquisition multiples and a discounted cash flow analysis – these methods are explained in detail in Chapter 17 and Chapter 19. In a public transaction, the fairness opinion needs to be approved by the fairness opinion committee and disclosed through an SEC filing.

**CLOSING**

Prior to closing and funding, there are additional approvals needed to fully complete the transaction including regulatory and shareholder approvals. The regulatory approvals required for M&A transactions involving publicly traded companies fall under the Hart-Scott-Rodino Antitrust Improvements Act of 1976. Under this regulation, every M&A transaction for publicly traded companies requires approval from the Federal Trade Commission (FTC) and Antitrust Division of the Department of Justice (DOJ). Following the execution of the definitive agreement the company needs to file with these agencies. The approval process typically requires 30 days to issue confirmation of the transaction depending of the size of the company, it’s revenues and assets. These set amounts are constantly adjusted each year for inflation.

The shareholders also need to approve the transaction. Before a scheduled shareholder meeting is set for approval, a proxy statement is sent out to the shareholders describing the transaction, the fairness opinion and parties involved. Shareholder approval is typically determined by majority vote (50.1%).

While the approvals are in the review process for both the government agency and shareholders, the investor buying the company proceeds to source the necessary capital to close and fund the transaction.

CASE STUDIES AND PRACTICE CASES

Is provided by is a supplemental book accompanied this text book under “Chapter 6 Case Studies and Practice Cases”. To access the excel spreadsheet applications used in this Chapter go to [www.ProfessorDrou.com](http://www.ProfessorDrou.com) under Text Book Spreadsheets.