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Capturing Value Through a Virtual Merger

Shifting value usually captured by an investor back to business owners.

by Mark Working

In a consolidating industry, there is often value to be earned by merging the operations of competitors—removing redundancies and optimizing capacity unlocks additional profitability. Rarely do similarly-sized or competitive private businesses merge, due to the challenges of aligning on vision, control, strategy, and relative valuation. As a result, the instigator of consolidation is either a strategic party who buys and absorbs a business, or a private equity investor who buys a platform company and then buys others in the industry. The value gained in integration of the businesses usually accrues to the buyers, not the sellers, as the reward for originating, developing, and executing on a specific investment thesis.

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We have found that if multiple sellers can cooperatively market their businesses as a virtually combined entity, so that a buyer is evaluating the post-integration asset rather than its constituent pieces, then the sellers can capture a meaningful portion of the synergy value. We call this process a **virtual merger**.

ISSUES WITH COMPETITIVE MERGERS

As stated previously, actual mergers among competitive businesses are rare. Integration requires a single plan with a single team having the authority and responsibility to achieve the goal. This requires that one management team and one plan has to be implemented. This issue is dampened when two public companies merge, as the issue of control is less important to the shareholders (as they are a minority shareholder in either regard) and the shareholders have a liquid market as a path to exit if they differ with the direction of the company. This doesn't hold in the merger of two private companies, as usually one shareholder group will be a majority and the other a minority, and the loss of control by one of the groups and therefore the exchange of a control security for an illiquid non-control security is hard to swallow. This can be especially challenging if there are different investment horizons among the shareholders and a lack of mutual familiarity or trust. In some cases, owners can overcome these issues as a result of the significance of the value gain, but it is uncommon. Capital is the catalyst. A path to liquidity, introduced by a third-party buyer, can be the key to cooperation.

A VIRTUAL MERGER

VIRTUAL MERGERS DEFINED

The next best thing to an actual merger is a virtual merger. In a virtual merger, two companies have identified specific synergies to be achieved in a combination, have developed a specific plan to achieve those synergies, have entered into an agreement to merge (but have not), and have gone to market to find a buyer for the combined entity. From a buyer's standpoint, a well-executed virtual merger has teed up a turnkey consolidation, eliminating the initial steps of originating a thesis, finding companies willing to sell, and constructing a detailed merger plan. The buyer still has to execute on the consolidation and future operation of the business, so there is still risk involved (and opportunity to earn a return). But in return for the value created in presenting a ready-made opportunity, the sellers would expect to be rewarded with a greater purchase price (on the basis of the combined economics) than if the businesses were purchased individually. The perceived quality and completeness of the integration plan and the certainty of the synergies determines how much of the combination value can be captured by the individual company owners.

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In a recent assignment, we represented two companies in the seafood industry where there were significant operational efficiencies to be gained in a combination. The shareholders of Clipper Seafoods and Blue North Fisheries had considered selling all or a part of their in-

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dividual firms prior to joining forces, and one of the leaders wanted to retire. We worked with them to develop a very specific integration plan of operations, leadership and capital structure, until the entities were "merger-ready". The larger and more profitable combined business attracted a different group of investors who appreciated the size and market position of the combined companies. A transaction was completed with an Alaska Native Corporation, Bristol Bay Native Corporation, that gave the investor a position that would have been difficult to gain on its own—and the owners of Clipper and Blue North were rewarded with a value for their businesses that exceeded what they could have received individually. Buyer and sellers alike were pleased with the outcome of the transaction.

NECESSARY CONDITIONS

This all sounds easy, but certain conditions are necessary to accomplish a virtual merger.

- The synergies must be real, realizable in a reasonable time period, and be quantified. The plan must be specific which means making decisions about managers and cost cuts. The hard decisions need to be made up front, not left to later. The value of these synergies will be discounted for time and risk of achievement so the degree of planning, the conviction of the management team in achieving the plan, and the willingness of the business owners to remain and share in the actual results all play a part in the ultimate determination of value.
- Joint agreement on investment horizon is helpful. When liquidity is desired as part of the initial transaction, this provides a common goal among the parties.
- It is important that all parties have reasonable expectations from a transaction and that they agree in writing to a commitment to move forward under a defined set of circumstances (including value). This needs to be thought through carefully as there will be a lot of work (and cost) involved and second-guessing of the goals at a later date will be disappointing at a minimum.
- The parties must agree on a relative valuation in the absence of a market transaction (and therefore a share in the synergies) so that the opportunity in its entirety can be offered to a third party. All negotiations with the new party will be as if the two businesses have already been merged. It is important that no "one-off" issues need to be decided later.
- The shareholders of the two businesses must have an ability to work together and resolve issues. Some degree of mutual respect must be there at the outset as there will be many issues between the groups that will require mutual trust.

OVERCOMING HURDLES

Because companies where there will be synergies when combined are often in the same industry and even might be direct competitors, the biggest hurdles can be real and logical (anti-trust considerations) and emotional (egos around relative importance). If those can be overcome, the mechanics require close collaboration and coordination. Each party needs legal representation but there also needs to be a lead transaction attorney (could be either party's attorney, or a third-party attorney). A mechanism to handle indemnification liabilities between the two parties must be established to fairly allocate responsibility under a likely joint and several scenario. Even though a third party will change the dynamics, an operating agreement among the business owners prior to a transaction needs to be established, and a shareholders' representative needs to be selected to make decisions following the transaction.

Completing any transaction is complicated and challenging. Adding an additional party to a transaction adds more than double the complexity and cost. But from both the buyer's and sellers' standpoint, the payoff can be well worth the effort. Planning is important in any transaction, but in this case, it is critical. Having an advisory team that has previously sailed these waters is invaluable. **ZS**

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ABOUT ZACHARY SCOTT

Since 1991, Zachary Scott has assisted owners of privately-held businesses in the greater Pacific Northwest to plan and execute major business or ownership transitions through three service lines: sell-side M&A, acquisition and investment advice, and direct investing. For more information on Zachary Scott, go to **ZacharyScott.com.**

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