

TECHNOLOGY ACQUISITION UPDATE

How to Select an Investment Banker

Experience, Commitment and Character

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This article is intended to help CEOs, entrepreneurs and boards of directors make better decisions when hiring an investment banker for an M&A engagement. In my experience, technology CEOs and venture capitalists don't always ask the right questions when selecting a banker. The article discusses the three most important criteria – experience, commitment and character. Sixteen good questions to ask are presented for interviewing candidates.

Every transaction will have problems of some kind. The seller wants the highest price and the buyer wants the lowest price. These are diametrically opposed positions. It is no wonder that issues crop up. Every deal encounters obstacles that must be overcome. Experience is far and away the most important benefit that an investment banker can bring to his client. The broader one's base of experience, the more effective the banker will be at solving the problems that inevitably occur.

First of all, what is the company's goal? What does it want to accomplish by hiring an investment banker? There are usually three primary objectives:

1. Get a transaction closed.
2. Close it with the best buyer, at the best price and best terms.
3. Close the transaction in a timely manner, with the fewest problems, and a minimum of disruption to the company.

The Classic Dilemma

Sellers often face a dilemma when choosing an investment banker to sell a company for less than \$30 million. Should they choose a

small boutique firm? Or, should they choose a larger investment bank?

The larger firm may have more people and resources; however, there is always the danger that the transaction will be turned over to a junior staff person. Generally transactions under \$30 million do not receive full attention from larger investment banks. They simply cannot earn a large enough fee to make it worth their while.

The boutique firm often provides greater attention and more personal service. In addition, the principals of a boutique firm may have more years of experience doing deals than the partners at a bigger firm. The deal may be more important for the boutique firm. Remember that you hire the person, not the firm.

Ego also comes into play. A company owner would rather tell his friends that he has hired Goldman Sachs to sell his company than some less familiar boutique investment bank. It is typical for companies to want to hire the biggest name investment bank that will work with them. The client is not always well served in these instances.

The Rolodex Myth

There is a pervasive myth that contacts or “knowing a space” is the primary driver for selecting an investment banker. I am frequently asked: “Do you have any contacts in the XYZ industry?” or “What space have you worked in lately?” However, I am rarely questioned about my skills or experience. Many CEOs and VCs mistakenly believe that successfully closing transactions is all about contacts or industry knowledge.

This myth is perpetuated by the large investment banks. A key element of their sales pitch is that they have access to the CEOs and decision-makers of the potential buyers. This is true for deals over \$100 million, or even over \$50 million. Large investment banks are organized along industry lines – healthcare, telecommunications, manufacturing, retail, etc. Each of these industry groups is a like a club and having connections with the right people is important.

Deals under \$30 million are an entirely different situation. The software and technology market space is like the wild West. The landscape is huge and things are changing all the time. There is no private club. Rapid movement and blurry market sectors are the rule, not the exception. Access is not a problem. CEOs of tech companies are quite interested in knowing which companies are for sale. They will respond if they are interested. Making the contact is simply not an issue.

In addition, the half-life of contacts is extremely short. Let me give you an example. A few years ago, I undertook a search for a buyer in the same exact market that I had examined two years earlier – network security. Two thirds of my original contacts were gone. Either they had changed jobs or the companies were acquired, merged, or out of business.

The key competency that an investment banker brings to a transaction is overcoming the difficulties that arise. Making contacts is the easy part.

The Myth of “We Know This Space”

Too much stress is being placed on industry knowledge. Bankers with limited experience

like to play the industry knowledge card. Industry knowledge is certainly a good thing, but it is no substitute for experience.

Industry knowledge can be learned in a relatively brief time frame. Investment bankers are highly skilled at researching and analyzing specific market sectors. One can review industry newsletters, study competitors, and perform basic Internet research and gain a very clear picture of an industry.

A broad base of experience, on the other hand, takes many years to obtain. Only experience produces the comprehensive set of skills that can solve the problems that arise, not industry knowledge.

Selecting an Investment Banker

The best investment bankers have three qualities that enable them to close transactions successfully and get the best price for their clients – experience, commitment and character.

Experience

The person with the broadest experience will have the greatest range and depth of skills for resolving solve problems. He will have a large data bank of successful solutions that were used in other transactions plus rich creativity with which to resolve issues. Experience also enables him to manage the process effectively and close the transaction at the best price and terms.

What is important with respect to experience? How should one examine experience? Let’s explore the six key aspects:

- Experience with intangible value
- Experience with technology markets
- Experience with similar size transactions
- Negotiating experience
- Creativity
- Deal savvy

Experience with Intangible Value

Almost all technology M&A transactions involve value that is strategic or intangible. In other words, the value is not a function of a company’s earnings. Value is a function of the

company's technology, customer base, intellectual property, engineering team, etc. The value in these deals is strategic. It will almost always be a greater value than one based on profits.

Many people are uncomfortable with the concept of intangible value because it is uncertain and often ambiguous. The concept of multiple of revenues is bogus – the range is too wide and comparisons are rarely valid. However, it persists. People are not comfortable without a number for value. The right M&A advisor will have experience negotiating transactions in which the value is strategic, not financial.

Dynamics of Technology Markets

Understanding the dynamics of technology markets is critical. These markets operate differently than other markets in our economy. They are fast-moving and fluid. An investment banker who has worked extensively in the technology markets will have a much better understanding of how to close transactions in this rapidly changing arena.

Experiences learned in one market sector can carry over to other areas of the technology markets. A sector that is consolidating has different dynamics than one in the early stages of growth. In a consolidating sector, motives for acquisition change and valuation metrics change.

The importance of adjacent markets is another concept with which the banker must be familiar. The best buyer for a company may not be in the core market, but in an adjacent market. The acquirer will use the acquisition as a means of market entry.

Experience with Similar Size Transactions

Another pervading myth is that deals under \$30 million should be run by the same process as large M&A transactions. A \$250 million or \$500 million deal is a totally different transaction than a \$10 million deal. Large transactions utilize the two-step auction process which is generally not appropriate for smaller technology deals. There are many more buyers for a \$10 million company than for a \$500 million company. The best buyers are often companies with revenues of \$50 million to \$100 million who do not have

dedicated M&A staffs to respond to the auction timing. Often, they need to move more slowly and at their own pace.

Investment bankers who try to run an auction process on small deals are trying to put a round peg into a square hole. The best price and the best terms are not achieved for the client. A negotiated transaction, on the other hand, takes more time and more effort but the results are much better. Don't assume that the process that works for large deals is best for smaller deals.

Negotiating Experience

Effective negotiators have three primary skills: people skills, communication skills and problem-solving skills.

Closing a deal means working with people. It means overcoming people's problems, desires, and emotions. Buyers have different approaches, different motivations, different opinions of value, and different negotiating styles. The more experience an investment banker has dealing with many types of buyers, the better job that banker can do for his client in dealing with the current set of buyers.

Communication skills involve not just the ability to state one's points, but to make sure the other side clearly understands them. Keen listening skills help a banker understand the other party's issues. What are they trying to accomplish? What are their priorities?

The experienced deal maker anticipates issues before they come up. He heads off minor problems before they become bigger problems. He knows what roads to go down and what roads to avoid. There are difficulties in every transaction. In fact, 40% of all transactions blow up at least once. It takes experience to get these deals back on track and to a successful conclusion.

Imagination and Creativity

Imagination and creativity are the qualities that separate the good deal doers from the great deal doers. The reason why is that really tough problems cannot be solved any other way. Tough problems demand that the investment banker step back and take an out-of-the-box approach. It is imperative to view the problem from entirely new angles. Only

then will one devise a new, creative solution. Does the banker have creative skills? Can he think outside of the box? Can he approach the problem with an imaginative mind set?

Deal Savvy

Deal savvy is presented last because it is the most elusive. It is difficult to define, but you know it when you see it. It embodies instinct. Deal savvy, or street smarts, means simply knowing how to make deals happen, how to get deals done.

It is a little like a game of poker. If you're good at calculating odds you might be a reasonable poker player. However, you can never be a great poker player without the ability to effectively read people. Most all poker players can calculate the odds, but reading people is a skill of the truly great players.

Deal savvy enables the banker to effectively deal with bluffs, false objections and other impediments. He will know how to discover any weakness in the other side. An investment banker with deal savvy can juggle several uncertainties at one time, float a few trial balloons, and work effectively with moving targets. He will find a way to get the deal closed.

Commitment

Will the investment banker give fully committed attention to the client? Is the deal large enough to get the banker's interest? What priority will be given to the client? Will he aggressively pursue all alternatives?

Commitment is important because deals can often reach an impasse. When the going gets tough will the investment banker fade away and move on to the next transaction? Or, will he stick with it, hang in there, scratching and clawing his way to close the transaction?

During slow times, a large investment bank may reach down to take on smaller transactions to keep their people busy, or use a small deal as training ground for their junior associates.

Senior level attention is something you should demand. Who will be the individual working on

your assignment? Is it a senior partner or will the assignment be handed off to a junior associate? Many investment banks are organized this way – the senior partner brings in the deal and the junior associates do all the work. Who will be working on your deal?

Character

Character embodies trust, integrity and chemistry. Integrity takes two forms in the context of a transaction. The first is integrity with respect to the client. This means communicating issues that the client needs to know honestly and truthfully. The investment banker should have the integrity to inform the client about all aspects surrounding the transaction, even the bad news.

The second aspect of integrity relates to negotiating. Negotiations will be more fruitful when each side has trust in the other side. So, when one side states their position they don't back out of that position later; that they stay true to their word. A banker who is constantly shifting his requests or positions does not generate trust. When you can't trust the other side, it makes reaching agreement much more difficult.

The sale of a company is one of the most significant transactions in many peoples' business lives. You should enjoy and respect the people with whom you are working. In addition, good chemistry between people is an excellent foundation for discussions should a problem arise. The principals of a company will be spending a good six months with this advisor so choose wisely.

In Summary

The broader one's experience, the better that person will be at overcoming the problems that inevitably occur. Contacts and industry knowledge are nice, but they pale in comparison to a broad base of experience. It is only through experience that an investment banker develops a rich set of skills that aid in getting transactions closed.

16 Good Questions

Basic Questions:

1. Describe the methodology of your sale process. How long will the process take?
2. What is your strategy for communicating with potential buyers? Do you plan to contact any of our competitors? Will you approach financial buyers?
3. How will you approach the valuation issue? What do you see as our most valuable assets or capabilities? (Don't get snowed by an investment banker who is trying to win your business by suggesting a very high valuation. Inflated expectations can lead to a number of problems.)
4. How will you manage confidentiality? When should we use an NDA?
5. Which individuals will do the actual work on our transaction? Who will draft the descriptive memorandum?
6. How much time and effort should our management team expect to devote to the sale process?
7. Who will handle the negotiations?
8. What kind of reporting to us will you do during the assignment? How frequently will you report?
9. What kinds of transaction structures would you expect? Where might you foresee any problems with the transaction?

Questions about Transaction Experience:

- Every investment banker claims that he is experienced. So how do you differentiate the candidates to identify the banker who truly has the most experience? Ask them about some of the deals they have done.
10. What are some transactions you have completed that might be comparable to our situation? Were these transactions completed by other people in your firm or completed by you personally?
 11. Tell me about one of your more successful transactions – What made you effective? What issues did you overcome? What strengths did you bring to bear?
 12. Describe a transaction that ran into a serious obstacle. How did you overcome it? Can you give me an example of how you used creativity to solve a deal problem?
 13. Describe a transaction in which you were not successful in selling the company. Why didn't it sell? What would the CEO of the company say about you and your efforts?
 14. What is your depth of international experience? Tell me about an international transaction that you completed. (Sometimes international reach can be important. In my experience, 15% to 20% of the prospective buyers are located overseas.)
 15. Do you have any conflicts of interest or other relationships with firms in our market that might impact this transaction?
 16. What differentiates your firm?

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