TECHNOLOGY ACQUISITION UPDATE

Merging with a Public Company

Merging with a publicly traded company often provides the selling company with a number of advantages including liquidity for shareholders, tax benefits, the potential for stock appreciation and access to resources such as capital, management and distribution capabilities.

Many entrepreneurs build companies with the goal of eventually achieving liquidity by either taking the company public, selling the company or merging with another firm. Generally the public market values the shares at a higher price than does a private buyer.

Companies go public for several reasons: first and foremost is liquidity for the owners' shares. Access to capital to support the company's growth is usually an important consideration. A publicly traded stock gives the company an advantage over a private company when using stock to make acquisitions. in addition, employee stock options, which are helpful for attracting and retaining key employees, have more relevance when the company's stock is publicly traded.

In order to be a candidate for a public offering, a company generally needs to achieve annual revenues of at least $20 million, have a record of consistently high growth, a defensible market position and a management team with a proven track record.

Sellers also may want to consider merging with a smaller public company. This may be a good alternative, particularly if the company has access to capital or is a good strategic fit.

Advantage of Merging with a Public Company

Merging with a public company may achieve many of an owner's goals. The seller achieves liquidity for his stock and has the potential for additional appreciation. The buying company may also have strong management and access to capital and distribution channels. Advantages include:

1. Liquidity. Shareholders of the privately held company exchange their shares for shares in the public company. They may eventually sell all or a portion of those shares in the stock market.

2. Access to capital. The public company typically can raise capital on favorable terms to sustain its growth, e.g., through a secondary public offering. The improved debt-to-equity ratio may allow the firm to borrow additional funds.

3. Access to Resources. The public firm is generally well staffed with management talent, has qualified marketing and sales personnel and technical talent. Additionally, public companies usually have established distribution channels and may have complementary technologies.

4. Strategic Reasons. Many of the reasons for selling may be strategic, i.e., product fit, economies of scale, marketing synergies or simply survival in the market. Market synergies can result from pursuing either the (a) same markets, or (b) complementary new markets. The Adobe-Aldus merger was between two companies addressing the same markets with similar product offerings and similar customer bases.

Accounting Considerations

Purchase accounting requires that each asset of the selling company be recorded on the books of the buyer at its current fair market value. This method requires that the goodwill of the selling company, which equals the amount of the selling price in excess of the value of the tangible assets, be amortized by the buyer. Since a large part of the value of many companies, particularly technology companies, consists of goodwill, purchase accounting can suppress a buyer's earnings for years.

Tax Advantages

An exchange of shares is almost always a tax-free exchange for the selling company, i.e., there is no taxable event. The sellers pay no taxes on the stock received but pay taxes when they eventually sell the stock. The sellers' tax basis remains the same. The selling shareholders have the flexibility of being able to sell their shares whenever they choose (or after the restricted period for control persons). Stock can also be gifted to children, usually resulting in a lower tax bracket when the shares are eventually sold.

Drawbacks to Merging with a Public Company

If you receive stock in the sale of your company, you are marrying your fortunes with those of the acquiring company. The potential exists for the stock to increase in value—or decrease in value. Drawbacks may include:

1. Potential Lack of Immediate Liquidity. The shares of a small public company, with a market capitalization of less than $50 million, may not be very liquid. (Market capitalization is the number of shares outstanding multiplied by the stock price.) It may not be possible to sell a large block of stock in the market simply because there may be very few buyers.

2. Restricted Stock. The public company may wish to use unregistered or restricted stock in the acquisition. Restricted stock can be sold after one year subject to certain volume limitations and can be sold without restriction after two years. If a selling shareholder becomes a 10% shareholder of the acquiring public company, that shareholder is subject to volume limitations and SEC reporting requirements on transactions in the acquiring company’s stock.

3. Market Volatility. The public company could suffer a substantial decline in its stock price due to economic events that occur well after the merger.

4. Business Risk. The company's core business could decline or management could take actions that adversely affect the company. The net result is that the stock price could fall.

5. Market Perception. The market may respond negatively to the merger, as in the case of Macrovision and Gemstar in which Macrovision's share price fell 25% the day the merger was announced. The market may believe the purchase price was too high, the strategic fit was inappropriate or that the synergies cannot be realized. The merger could result in a lower share price for everyone.

Key Issues to Consider

Liquidity. Are enough shares traded to establish a real market? Are the shares actively traded? What is the daily trading volume—just a few hundred shares or many thousands? Some smaller companies have very little trading activity, which makes it difficult to sell even a moderate number of shares without driving the price down.

Find out what the float is. Float is the number of shares in the hands of the public that are available for trading. If only a limited number of shares are available to trade, it will be difficult to liquidate stock.

If a selling shareholder merged his firm for $8 million in stock and later decides to sell the shares in the market, he may find it difficult to sell that many shares without pushing the price of the stock down significantly.

Appreciation Potential. What is the outlook for the future financial performance of the acquiring company? Do your homework—check out the stock and its appreciation potential. Ask yourself this question: If you had received cash instead of stock, would you purchase such a large quantity of the public company's stock?

Review stock analysts' reports. Ask the company what analysts follow the company and get a copy of recent reports from their brokerage firms.

Transaction Structures. Consider whether your objectives will be met by exchanging stock, or receiving cash or royalties. Royalties may be more directly related to the success of your products in the marketplace. In an exchange of stock, there are three basic transaction structures:

1. A Fixed Number of Shares. The buyer exchanges a fixed number of shares for all of the seller's stock. There is a risk that the stock price could fall after the merger announcement. This may not be a problem in the long run, but it is not a good short-term development for shareholders who want to liquidate soon.

2. Minimum Cash Equivalent. The buyer guarantees the sellers a minimum share price and makes up the difference in cash. Gamma Corp. assured Delta Corp. shareholders a minimum price of $72 per share and will make up the difference in cash if the price falls prior to the deal closing.

3. Fixed-Dollar Amount with a Flexible Number of Shares. The buyer makes up any difference in the agreed price with additional shares of the buyer's stock.

Conclusion

Company owners who are evaluating their exit strategies should consider a merger with a public company. It may not always be as appealing as a public offering, but the advantages of liquidity, tax benefits and access to capital and resources make it an alternative worth considering.