

THE MANAGEMENT JOURNAL FOR CORPORATE GROWTH

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DALLAS

## SMART LEADERS

Jani-King's Jerry Crawford on why hiring someone with a little ego can be a good thing

## FAST LANE

Fogo de Chão's Jair Coser on why you need to open your books to your employees

# 10 steps forward

How Lynn Blodgett leads 58,000 entrepreneurs to billions in revenue at Affiliated Computer Services

# The technology boom

Analyzing the high-tech Merger & Acquisition boom **Interviewed by Curt Harler**

**M**erger and acquisition (M&A) activity in the technology sector is booming. Both the volume of deals and the transaction values are at some of the highest levels ever. According to The 451 Group, a company that tracks technology deal-making, buyers announced 1,900 transactions worth \$347 billion in the first half of 2007. While this is a slight decline from last year's deal flow, spending was almost 50 percent higher than in the first half of 2006.

*Smart Business* asked Lawrence B. Mandala, chairman of the Corporate Transactions and Securities Practice Group of Munck Butrus Carter, P.C., a Dallas-based law firm, about the tech buy-out frenzy, tech company valuation, and the increased use of earnouts and other contingent payment arrangements.

## Why is tech M&A so hot?

First, there has been a lot of spending this year by the private equity (PE) firms. Not that many deals, but very high-dollar transactions, like the pending buyouts of First Data Corp., Alliance Data Systems and CDW Corp. Those transactions by themselves account for over \$43 billion of the tech M&A deal value this year. Second, market conditions have been very good for the tech buyer for the last year or two. Low interest rates, higher profits, readily available financing and increased stock prices (at least until this July) all fueled the buying spree. A number of large cap companies and PE firms have big cash balances they've wanted to put to work.

Investors look at the technology sector for several reasons. First, tech companies are more mature, with more stable earnings histories, than at the height of the dot-com boom. This makes them more attractive to the buyout firms. Second, tech companies have become used to growing at double-digit levels. Companies are using acquisitions to fill the gap between growth they can deliver internally and their growth targets. They use acquisitions to add new lines of business, as well. Finally, many



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tech industries are fragmented, so there is a drive to consolidate some market segments, like business software. Big companies have the resources to get the deals done, and small companies are wondering if now is the right time to sell and become part of a larger enterprise, rather than go it alone.

## Is it difficult to value a technology company?

Valuing a tech company can be very different than valuing other types of businesses. For example, if the company is new to market, it might not have a traditional valuation metric like profits. Even if it has earnings, the last year or two may not bear any resemblance to expected future results. If the company has a unique product coming to market, there may not be competitors to measure the company's progress against. If it's a private company, or a public company with a volatile stock price, there won't be a reliable market value for the company. In each of these cases, the parties may have a more difficult time agreeing on a valuation. It's also harder to value intangible assets like intellectual property (IP) than tangible property like

inventory, real estate and equipment. While IP rights may be important to every company, the tech company's IP is frequently among its most important and valuable assets. Valuation differences between the buyer and seller ultimately lead to more use of contingent payment structures like earnouts or royalty payments.

## When should a seller include an earnout or royalty payment in a transaction?

Earnouts bridge a valuation gap. If the seller believes his business has growth potential and the buyer is unwilling to pay now for unknown future performance, the parties might include an earnout in their deal structure. In an earnout, the buyer doesn't pay the entire purchase price at closing. He pays a certain amount now and more later depending on the financial performance of the acquired business. Earnout milestones could include targets for revenue, gross or net earnings, or EBITDA. An earnout may allow a seller to realize a higher sales price if the business performs as the seller believes it will. It can also be a vehicle to defer taxes. An earnout reduces the buyer's initial expense of acquiring the business and minimizes the risk of overpaying based on uncertain projections of future performance. An earnout also motivates the seller's management to stay with the business and contribute to its future success.

Royalty payments can achieve many of the same goals. If the seller believes the buyer is not paying enough for a particular invention, for example, he might propose the buyer pay a royalty on future sales.

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