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First Half Fall 2023 Business and M&A Legal Developments

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A Look at Q2 M&A and Beyond: Are Conditions Ripe for a Strong 2024 M&A Rebound?

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Much has been said about the return of M&A in 2023, and while there are deals happening, it is not the boom that many expected. But could all that change in 2024? Is this year setting the stage for a return to more deals getting done?

Pitchbook has released its Q2 2023 M&A Report, and the findings are quite interesting, showing that deal volume and deal value are diverging. The report shows price multiples in correction mode, with an approximate 20% drop since peak levels in 2021. This is coupled with the fact that acquirers are focusing on smaller-scale deals right now as interest rates remain high, and they are sitting on very large amounts of dry powder. Pitchbook notes that this has led to a 33.7% drop in deal value, but the deal count remains steady.

Dry powder is the cash reserves and liquid securities that private equity or venture capital firms have on hand to deploy when the conditions are right. According to Crunchbase, global PE dry powder is estimated to be $1.3 trillion and venture capital is estimated to be sitting on about $580 billion. So, even though firms have enormous amounts of dry powder in reserve, they are still faced with tight credit conditions at the same time.

Tight credit markets can create challenges for PE firms looking to execute mergers and acquisitions, even with large amounts of dry powder. They can lead to increased financing costs, limited funding options, reduced valuations, longer deal timelines, and a more cautious investment approach. These factors can collectively impact the ability of PE firms to pursue and execute M&A transactions successfully.

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But there may be some light at the end of the tunnel. Reuters reports there are signs of a revival in investment banking, with Morgan Stanley recently predicting an uptick in spots of M&A. Pitchbook also points out that Goldman Sachs showed an increase in investment banking backlog, something that can "open the liquidity floodgates." When you look at this in combination with the dry powder on hand, we might see that spike in M&A we have been waiting for next year.

Only time will tell if 2024 will be the return to M&A activity we have been waiting for, but it seems that the right conditions might be falling into place as the economy stabilizes and interest rate hikes slow down. We will be watching closely for more signs of an M&A boom possibly in the near future.

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The Importance of Due Diligence in M&A Transactions

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In any merger or acquisition, the due diligence stage is one of the most critical steps. It allows the acquiring company to identify dealbreakers, assess risks, make informed decisions, negotiate effectively, ensure compliance, plan for integration, and set the stage for a successful and value-enhancing merger or acquisition.

The acquiring company, with its legal, tax, and financial advisors and other advisors, must carefully examine several areas of the target organization in great detail to identify any issues with their financial, operational, technological, regulatory, tax, and other departments. Below, we look at the areas of examination necessary for a comprehensive due diligence process.

Financial, Accounting, and Tax Due Diligence

Financial due diligence involves analyzing the target company's financial statements to fully understand its finances and internal controls on how they are prepared. Acquirers should review revenue streams and cost efficiency to better reveal the economic landscape. Acquirers should pay particular attention to any difference in accounting standards adopted by themselves and the target companies and whether any material liabilities are not reflected in the financial statements.

Examining revenue, cost drivers, profitability, and financial patterns will help uncover influencing factors, and focusing on earnings quality and reporting accuracy can assure data dependability. Looking at cash in and cash out will identify essential patterns and sequences, seasonality, and credit risks.

Buyers should consider the qualities of the financial statements and balance them against the corporate lifecycles of the target companies and the closing processes. For example, early-stage or

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closely-held target companies may not have prepared audited financial reports, and acquirers should consider supplementing these financial statements with additional representations, for example, absence of undisclosed liabilities representation, accounts receivable collectability representation, etc.

Tax diligence is another critical aspect. From a structural point of view, particularly in a scenario where at least a portion of the consideration is payable in stock, acquirers and targets must understand whether a transaction could qualify as a tax-deferred reorganization. If not, it is up for negotiation whether a portion of the consideration payable to equity holders should be in the form of cash to enable these holders to make their tax payments. From an operational point of view, acquirers will want to understand matters such as whether the target has paid sales tax to each of the states and other jurisdictions where tax could be imposed, whether the target has employees in a state where it does not pay sales taxes; has the target business taken advantage of potential research and development tax credits and other government incentives; transfer pricing allocating revenues and costs among the different group entities, etc.

Legal Due Diligence

Legal due diligence entails an in-depth investigation of the target company's current and historical legal status. It involves evaluating legal structures, ownership, securities laws compliance, stockholder agreements, management, and its authorities to enter into the transaction. Material contracts, agreements, and obligations should go through a thorough due diligence process to identify any potential liabilities. To the end, at Foley, we have licensed an AI tool called "Kira," which aids and greatly reduces the time attorneys need to review them.

Examinations of intellectual property status, commercial rights, and any pending litigation are crucial in determining legal hygiene. These evaluations include portfolios of patents, trademarks, copyrights, and trade secrets. Verifying the acquiring company's licenses and permits also ensures the business operates legally.

Suppose existing customer contracts are an integral part of the transaction. In that case, acquirers will want to diligence the material customer contracts constituting a significant percentage of its revenue to determine the terms of the contracts and whether the counterparties have a right to terminate by convenience, whether these agreements contain any restrictive covenants, whether consents from these counterparties are required, as well as other commercial arrangements with the customers.

If the target engages in a regulated business, special attention should be given to regulatory compliance diligence. Acquirers should also work with target companies from the outset to determine the HSR (antitrust) or CFIUS (foreign investment) implications of the transaction.

While we call this area of due diligence “legal,” it uncovers key inputs to target enterprise value just as critical as the numbers.

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Operational Due Diligence

When conducting operational due diligence, buyers must examine how a company or business runs on a day-to-day basis. Understanding how the industry works, including systems, processes, and infrastructures, helps unearth strengths, flaws, and possible risks. It may help if the acquirer is engaged in a similar business to the target company so that the acquirer understands the industry's landscape well. The goal is to understand daily business operations, determine efficiency, and find practical problems.

Possible operational risks, such as weak points in the supply chain, problems with production, and capacity limits, are identified to understand their effects on general operations. The company's customer base, market position, and competitive landscape are assessed to learn more about its impact on the market and how well it competes. Conducting operational due can also help identify any issues with future integration and improve operations for long-term success.

An essential benefit of operational due diligence includes identifying revenue synergies. For example, are there overlapping customer relationships that can be amplified by multiplication rather than addition? Can costs be saved by a factor of division rather than subtraction? Can contract revenues be extended? Can customer retention be improved? Are there opportunities for customer upsell?

Technical Due Diligence

Technical due diligence thoroughly analyzes the target company's technical components, including examining hardware, software, cybersecurity, data privacy, open source adoption, scalability, innovation potential, dangers, and networks comprising its technology infrastructure. The system's versatility, dependability, and security are investigated meticulously.

Technical due diligence helps stakeholders make well-informed choices about the company's technological readiness and compatibility for successful integration.

Customer Due Diligence

A thoughtful customer due diligence investigation will identify growth opportunities and solicit feedback on increasing market share after the transaction closes. Acquirers typically will want to be connected to target companies' customers. Still, target companies would typically request that acquirers develop a communication plan with them to preserve confidentiality before closing and maintain customer relationships.

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Team Due Diligence

Employment or team due diligence involves checking that all contributors are correctly classified as employees or independent consultants and that these individuals have executed assignment agreements assigning their rights to IP to the target companies. Acquirers would want to ensure that the target companies have complied with employment laws and that they understand the implications that the acquisition will have (i.e. whether such will be accelerated) on employee equity grants. For integration purposes, titles, compensations, and responsibilities of target companies' employees should be mapped against those of the acquirers to make competitive offers to the individuals. If there are any critical employees on which the operation of the target's business depends, the acquirer should consider requiring their execution of offer letters and contractor agreements as closing conditions.

Conclusion

These are only some areas that a thoughtful due diligence investigation will cover. Doing your due diligence is a key factor in the success of any acquisition, before and after the closing, and for many years to come.

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The Stock Market is Ready, So Where Did All the M&A Deals Go?

No one can predict the lasting effects of an economic downturn for certain and whether tech M&A activity will ebb or flow. However, current economic conditions present many aspects of the ideal buyer's M&A market.

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While pundits have predicted a recession in the United States for well over a year, the U.S. economy has been growing at a steady clip since the third quarter of 2020. Following historical stimulus programs to bring the economy out of a pandemic-induced trauma starting in March 2020, culminating in the falsely named "Inflation Reduction Act" of 2022, inflation reached double digits. Unemployment is at record lows, and labor markets remain stubbornly tight. The Federal Reserve has been coordinating a historic tightening of monetary policies, raising interest rates by 500 basis points in less than a year, while shrinking its balance sheet and ending "quantitative easing" as we knew it.

Unsurprisingly, asset allocation has moved away from equity and other high-risk products given the higher cost of capital, and into higher returning debt products. This translated into a 20% fall in the S&P 500 in 2022. Also, the Dow Jones US Technology Index and NASDAQ fell by 35% and 33%, respectively, in 2022. Year to date in 2023, the stock market has been relatively flat, and the market for new issues has been tightly shut.

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So where did all of the M&A transactions disappear to?

To answer that question, we have to put it in context:

- As of the date of this writing, the Fed has made a 10 consecutive rate increase, bringing it above 5%, a first in over 15 years.
- The regional banking crisis, beginning with the failures of Silvergate, then Silicon Valley Bank, then Signature Bank and now First Republic, have shaken the business community's confidence in the banking system and bankers' appetite to extend credit.
- Inflation is still running hot at approximately 5%—although this has gone down by nearly half, this is still far from the Fed's target inflation rate of 2%.
- Geopolitical uncertainties—the war in Europe continues on, together with fears of an outbreak of war in other parts of the world, coupled with their collateral damages, e.g., the energy crisis in Europe.
- Global supply chains are in flux, never having recovered from COVID measures, and now responding to active war in Ukraine and cold war with China.

How have events impacted tech M&A activity? Conventional wisdom would tell us that with falling tech valuations, tech acquisitions would be on the rise. But is that actually the case?

Effects on M&A Activities

According to a recent law.com article, M&A activities in Q1 2023 saw a 44% decrease from Q4 2022, after experiencing a 37% fall from H1 2022 to H2 2022.

Looking to other data in the tech industry specifically, according to data taken from S&P Capital IQ, Pitchbook and MergerMarket, in the nine months ended Sep. 30, 2022, overall M&A activity was down by more than 40%.

Industries appear to have been affected by the economy to a varying degree. For example, while tech M&A was been down, M&A in the health care vertical has thus far in 2023 seen a 60% YoY increase in terms of dollar value.

M&A Outlook

We are cautiously optimistic as we look forward:

- With inflation dropping precipitously, and in the face of a regional banking crisis, the Fed has pressed pause on further tightening.
- After 17 months of a closed IPO market, regulators may pivot to enabling rather than blocking new capital formation.

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- A realignment of regional banks may lead to some lending after the pause we have seen in 2023.
- As inflation subsides, interest rates should stabilize, making acquisition financing more predictable and encouraging investors to deploy their dry powder.
- Dry powder has accumulated at historic levels within private investment funds and public companies, and investors will seek to take advantage of better times to put these funds to work. According to a recent Forbes article, dry powder for PE globally is estimated to be $1.3T, and that of VC globally is estimated to be $580B.
- Private equity firms who have been waiting for better financing and other conditions to prevail should bring their better-performing assets down from the higher shelves and to market.
- Sellers who have been holding out for better days will capitulate, and clearing the backlog should enable good trades for strategic and financial buyers.
- We expect buyers and sellers to structure acquisitions with stock to offer selling stockholders upside.
- Certain verticals, for example AI and cloud solutions, have remained resilient due to growth and development.
- Current strong dollar could make foreign targets more appealing to U.S. buyers.
- Tech companies' valuations are showing trends of stabilization.

We expect private equity buyers to increase their use of liquidation preferences at multiples greater than 1 times, participation rights, pay-in-kind dividends and forced redemption clauses to bridge valuation and risk gaps. We are seeing more earnout and deferred payment structures to protect capital invested but also expected return on capital invested.

Practical Ideas

The impact of hot war, cold war, geopolitical instability, another pandemic outbreak, or natural disaster can never be predicted, but there is reason to be optimistic. We expect that buyers and sellers will put their best feet forward by:

- Evaluating and controlling expenses within portfolio companies and securing additional bridge financing (whether equity or debt) to create a longer runway of cashflow.
- Identifying and cultivating commercial relationships with potential buyers and targets to mitigate risk, both strategic and financial.
- Building pipelines of targets through top-down strategic targeting and bottoms-up, opportunistic leads from the grass roots.
- Frontloading more detailed prep work in advance of launching a process in either direction, such as building a modernized valuation model that takes new market conditions into account, showing profitability in addition to growth, preparing a virtual data room, scenario-planning answers to difficult diligence questions, advance "quality of earnings" reviews and more 360 degree consultation with potential counterparties and ecosystem parties, as well as cleaning-up various house-keeping matters

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Some of this prep work should include a detailed look at your company's revenue and commercial agreements:

1. Examining whether contracts can be extended on a streamlined basis, automatically, and/or for extended periods.
2. Exploring pricing and timing of payments, including multiyear revenue deals with upfront cash.
3. Revisiting the ability of either side to terminate for convenience.
4. Extending debt maturities, securing new committed credit lines of all types.

All of this requires a strategy, proper planning and forward-thinking, proactive advisers who are all in.

Conclusion

No one can predict the lasting effects of an economic downturn for certain and whether tech M&A activity will ebb or flow. We continue to see economic conditions evolving daily. However, current economic conditions present many aspects of the ideal buyer's M&A market. So, looking ahead, we could continue to see an increased appetite for acquisitions as valuations stabilize at lower levels, inflation subsides and interest rates taper off.

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Positioning for the Exit at the Entrance

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Startup founders are constantly seeking ways to gain a competitive edge and secure their place in the market, including positioning their company as an attractive acquisition target from the very beginning. While building a company with the goal of being acquired requires careful planning and execution, it can lead to significant opportunities for growth and success.

The first half of 2023 has been a slower period of mergers and acquisitions than anticipated. A recent article by McKinsey reports that the estimated value of companies undergoing M&A in Q1 2023 fell by 49% from a year ago to $562 million. This could be attributable to various factors in the economy and the world we live in, e.g., climbing interest rates, inflation, geopolitical events, and the market's confidence in the economy. On the other hand, critical players in the M&A world are reporting greater optimism for the balance of the year. It is also generally believed that investment funds are sitting on significant piles of dry powder for deployment. A recent article by PWC estimates that private equity firms in the United States are sitting on about $1.1 trillion of dry powder. With an anticipated uptick in M&A activity, the second half of 2023 should prove an ideal time for startups to position themselves for acquisition when the time is right strategically. Below are some key tips for putting your best foot forward.

Develop a Strong Value Proposition

From day one, focus on developing a unique value proposition that sets you apart. Clearly articulate how your product or service addresses a specific market need and provides a solution that stands out from competitors. Conduct marketplace analysis to demonstrate how you are outperforming your competitors. Discuss with your financial advisor the best way to present and evaluate your enterprise value using the various models and formulas. A strong value proposition attracts

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customers and captures the attention of potential acquirers seeking innovative and differentiated offerings, product adjacencies, and growth accelerators.

Demonstrate Growth Potential

Startups that can show great growth potential will deservedly attract more attention from both investors and buyers. Showcase your startup's growth trajectory by consistently achieving milestones and exceeding performance expectations. Highlight key metrics such as revenue growth, customer acquisition rates, and market penetration. A track record of sustained growth and a clear path to profitability make your startup a more attractive proposition for acquisition.

Build a Scalable Business Model

Startups with scalable business models have greater potential for rapid growth and are more attractive to buyers. Design your business operations and processes in a way that can accommodate increased demand without significant increases in costs. This scalability makes your startup more appealing to potential acquirers and positions you for sustainable growth.

Focus on Intellectual Property

Intellectual property (IP) is a valuable asset and can form a moat around your castle. It can significantly enhance your startup's attractiveness as an acquisition target. This means it is critical that you protect your innovations through patents, trademarks, copyrights, and trade secrets. A robust IP portfolio demonstrates your commitment to innovation and can provide a competitive advantage that appeals to acquirers seeking to enhance their product offerings. From an early stage, you should work with your legal advisors to develop an IP strategy that protects your intellectual properties in a cost-effective manner. You should also ensure that all of your current and former employees and contractors involved in the development of your technology have validly assigned their IP rights to the business entity. Data privacy compliance concerns also tend to attract much attention from buyers in due diligence processes. Properly strategizing and executing IP protection can make you more marketable and help ensure smooth deal execution.

Engage Trusted Advisors

Consider engaging trusted advisors from day one of running your business. Having trusted M&A advisors will not only connect you to potential buyers but will also give you advice on how your business case can fit into these potential buyers' deal theories and how an acquisition could bring about synergies to the potential buyers. They will also be available to guide you and ensure the deal is executed efficiently.

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Cultivate Strategic Partnerships

Forming strategic partnerships and collaborations can boost your credibility and visibility in the industry. Aligning with established companies or industry leaders opens doors to new markets and increases your startup's perceived value in the eyes of potential acquirers. These partnerships showcase your startup's potential for integration and collaboration in a larger ecosystem.

Foster a Talented Team

Invest in building a skilled and dedicated team experienced in your particular field and in running an emerging growth business. Create alignment between your team members and your startup's mission and vision. Acquirers often value a strong and capable workforce that seamlessly integrates into their organization. Develop a company culture that attracts top talent and fosters innovation, collaboration, and adaptability. Many potential buyers, especially strategic buyers, pay much attention to cultural compatibility when evaluating an acquisition, that sometimes gets overlooked by potential sellers.

Housekeeping Matters

Ensuring good housekeeping from inception and at every step of your journey can speed up a due diligence process, reduce negotiations on representations and warranties with potential buyers, ensure a smooth representations and warranties insurance underwriting process, and generally promote better deal execution. There are a few matters that you could be frontloading:

- Obtaining an audit on your financial statements, and quality of earnings analysis
- Understanding the third-party consents required under your various contracts and whether these contracts contain restrictive covenants that could potentially make an acquisition less attractive to a buyer
- Revisiting prior equity grants and sales to ensure that they complied with the stock plan and the various securities laws exemptions and that the cap table accurately reflects the stockholding of the company, especially if part of this process is handled in-house.
- Ensuring that your employees and independent contractors are properly classified as such and as either exempt or non-exempt.
- Understanding the tax implications of an acquisition on your business and your team.

Positioning your startup as an attractive acquisition target requires a combination of strategic planning, focused execution, and a commitment to innovation. The more strategic founders can be from the start, the better they can pave the way for a successful acquisition and propel the company toward new heights of growth and achievement.

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Financial Metrics in M&A Transactions: Evaluating Valuation Metrics, Pricing, and Potential Returns

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Mergers, acquisitions, and buyout transactions are complex endeavors requiring careful analysis and consideration of multiple financial inputs and outputs. Both the acquiring company and the target company will each need to thoroughly assess the financial implications of a potential combination to ensure a successful outcome.

This post examines some key financial considerations in M&A transactions, including valuation metrics, pricing, and potential returns. We emphasize the importance of assessing the acquiring company's financial health and stability to determine whether the merger or acquisition will produce the desired outcome.

Valuation Metrics: Determining the Fair Value

Valuation is critical in any M&A transaction as it sets the foundation for pricing and negotiations. It involves determining the fair value of the target company based on its assets, liabilities, financial performance, market position, and growth prospects. Valuation methods may include multiples of revenue (with a higher multiple applied to revenue that is both recurring, growing, and profitable), discounted cash flow analysis, comparable company analysis, relative public market performance, and asset-based approaches. Each of these inputs can change the outputs, and extraneous factors like inflation, interest rates, dry powder at venture capital and private equity funds, and cash positions of strategic or public company buyers can impact each.

In today's economic climate, determining valuation can prove increasingly challenging. Many emerging growth companies are facing much lower valuations than they were a year or two ago, and

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some data suggest that the gap between what acquirers are willing to pay and what founders believe is a true valuation may be widening. So, determining a fair valuation agreeable to both sides is even more challenging today.

To accurately assess the value, qualitative and quantitative factors must be considered. The qualitative factors that should be regarded include industry trends, the competitive landscape, the target company's intangible assets, such as brand value and IP, and whether the seller's business will achieve higher growth by integrating the buyer's sales operations. In other words, can a seller's product on the buyer's platform instantly achieve growth by virtue of integration with the buyer? Quantitative factors involve financial ratios, historical financial statements, and projected cash flows. Looking at qualitative and quantitative factors allows the acquirer to understand better the potential synergies and growth opportunities the transaction may bring.

What is the "Rule of 40," and why has it become the primary driver of valuation metrics?

If you are the CEO of an emerging growth business, you will likely hear your investors and advisors talk about the "Rule of 40." Simply put, this is a way to derive enterprise value by measuring revenue growth plus free cash flow margin. In other words, if you base your business on recurring revenues, it is growing, and it is profitable, it should be worth more than a business whose revenues are transactional rather than recurring or is not growing as fast, or is not growing profitably (e.g., burning cash).

Before the market correction that began in January of 2022, enterprise value was primarily a function of revenue vs. revenue growth. According to a report by Guggenheim Securities, revenue growth's correlation with value has decreased by approximately 50% since November 2021, while "Rule of 40" growth's correlation with valuation has increased by approximately 130%. Today, "Rule of 40" growth is the primary driver of software valuations.

In software businesses, the growth vector and "Rule of 40" analysis will inform what multiple is applied to a company's last twelve months' recurring revenues, with highest growth and Rule of 40 companies (deemed to be "hyper-growth" at levels greater than 40%) now indexing to 9.7x times revenue (down from a five-year average of 20.5x and pre-pandemic average of 15.8x revenues) according to the Guggenheim Securities report dated July 3, 2023. Moderately growing and high-growth software businesses (e.g., growing from between 10% to 40%) will generate valuations of 6.4x to 6.8x recurring revenues, and mature growth software companies (e.g., growing at approximately 10%) will generate valuations of roughly four times recurring revenues.

Once you have understood the valuation metrics of your business, you can translate that into a structure, a price, and a deal.

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Pricing: Striking the Right Deal

Once the two parties have settled on fair valuation metrics, they must negotiate a price that satisfies both sides. The acquirer should closely look at the target company's strategic fit and synergy potential, as these factors can affect the ultimate amount the buyer is willing to pay. It is essential to strike a balance between paying a fair price and achieving the desired financial outcomes.

In addition to the purchase price, there are many other financial aspects to consider. This can include the assumption of debt, product liabilities, warranties, latent and patent risks, contingent payments, and other potential liabilities associated with the target. Conducting thorough due diligence to uncover any hidden risks that might impact the deal's pricing and overall financial feasibility is necessary.

Potential Returns: Assessing Financial Outcomes

Acquiring companies must look at the potential returns and financial outcomes very closely, including expected financial benefits, such as revenue growth, cost synergies, expanded market reach, increased market share, and improved operational efficiencies. Analysis should be conducted in the short and long term, considering the integration process and potential disruptions.

By conducting comprehensive financial modeling and scenario analysis, the acquiring company can assess the potential returns and validate the assumptions underlying the deal. Sensitivity analysis can help identify potential risks and uncertainties and provide insights into the potential range of outcomes.

Assessing the Financial Health and Stability of the Acquiring Company

When discussing due diligence in M&A transactions, much attention gets paid to evaluating the target company. However, it is equally essential for the target to assess the financial health and stability of the acquiring company. For the transaction to have long-term success, the acquiring company must have a strong financial position, and the target company should conduct its own due diligence and analysis.

Key financial metrics should be analyzed, such as liquidity ratios, profitability ratios, debt levels, and cash flow generation. Does the acquiring company have the ability to finance the deal? How does it impact its capital structure, debt servicing capabilities, and credit rating? Examining the management team and their experience executing successful M&A transactions is also important. All of these are critical factors that the target company needs to examine.

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Structure

In today's environment, where the chasm between sellers' expectations of value and buyers' willingness to pay has never been wider, the challenge is in bridging the gap. This is where structure can come into play. You can structure a transaction over time, with deferred payments that are either guaranteed or contingent, based on the passage of time and/or achievement of milestones. A transaction can be structured in installments or with dividends that are either cash or stock-based. A transaction can be asset-based or entity-based. Each of these structures can optimize tax benefits and debits that inform the final pricing.

Summing it up

Financial considerations play a vital role in the success of M&A transactions. They are essential for both the acquiring and target companies to make informed decisions and negotiate a mutually beneficial deal.

Now more than ever, both acquiring companies and targets should work with seasoned investors, advisors, and counsel to help guide them through the process.

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Cultural Alignment in Mergers and Acquisitions: The Key to Successful Integration

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The iconic management theorist Peter Drucker made famous the notion that "culture eats strategy for breakfast." In other words, the culture of your company is correlated more closely to your company's ultimate value and success than its strategy. There is a human factor at every level of every company. No matter how well-researched, educated, informed, and detailed, the strategy of a business ultimately depends on the people executing it. In a word, we call that "culture."

Every company has a distinct culture that makes it unique. Culture is what sets them apart, and it is often what creates loyal, long-term employees. In a merger, acquisition, or buyout transaction where two or more businesses combine, there can be a culture clash that impacts the ultimate success of the transaction. That is why, during the M&A process, it is critical to determine the cultural alignment between the buyer, the seller, their employees, customers, suppliers, and stakeholders more broadly.

When cultural compatibility is neglected, it can lead to significant challenges and hinder the post-merger integration process. Evaluating cultural compatibility is of great importance, including assessing values and management styles, as cultural misalignment can create significant obstacles in successful M&A integration.

Evaluating Cultural Compatibility: Before embarking on an M&A transaction, how does one assess the cultural compatibility between the buyer and the seller? What exactly is cultural alignment? It is the similarity or harmony between the two organizations' cultures, including shared values, beliefs, norms, and working styles. Evaluating cultural compatibility requires a comprehensive

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understanding of both organizations' cultures, which can be achieved through in-depth research, employee surveys, interviews, and site visits.

Assessing Values, Management Styles, and Workforce: Cultural alignment goes beyond surface-level observations and involves the fundamental values and management styles prevalent in both organizations. Below are just a few questions companies should be asking as they look at whether a merger or acquisition will result in a culture fit:

- Are their core values and principles compatible with ours?
- Do they have similar approaches to decision-making, communication, and collaboration?
- Do they have a good rate of employee retention?
- Could you see yourself or your own employees working there?
- Are decisions based on transparent, performance-based, and objective metrics, or are they based on opaque or subjective metrics?
- Does information flow freely within the company, or is it closely guarded by senior management? Arguments can be made for both the "open-box" and "closed-box" systems, but merging two companies with polar opposite information-sharing cultures is destined to be challenging for each side to adapt to the other.

Assessing these factors helps identify potential areas of synergy and areas that may require adaptation or compromise. Additionally, understanding the workforce's cultural dynamics is essential, as employee attitudes and expectations play a significant role in successful integration.

Cultural Misalignment Can Create Integration Challenges: When there is cultural misalignment, it can lead to significant challenges during the post-merger integration process. Some of the most common issues we see include:

- *Employee Resistance*: In an M&A transaction, employee retention and morale are critical. When there is a clash of values and working styles, employees may resist change, leading to decreased morale, productivity, and engagement. Integration efforts can be derailed by the lack of employee buy-in or an exodus of key employees.
- *Communication Breakdowns*: When two companies engage in wildly different communication styles and practices, misunderstandings, and misinterpretations will no doubt follow. Effective communication is crucial to aligning goals, managing expectations, and building trust between employees from both organizations.

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- *Leadership and Management Conflicts*: If the acquiring entity's leadership style differs significantly from the acquired company, conflicts can very easily arise. Varied management practices, decision-making approaches, and levels of autonomy can cause friction, impeding smooth integration.
- *Cultural Dilution*: When companies attempt to assimilate cultures too quickly, there is a risk of losing the unique aspects of each organization's culture. This can lead to a loss of identity, decreased employee satisfaction, and talent attrition. Remember, your unique culture is so much of what attracts and keeps your employees. If that is lost, your employees could soon follow.

Strategies for Successful Cultural Integration: To overcome cultural misalignment and ensure successful integration, consider the following strategies:

- *Cultural Due Diligence*: When you are conducting your due diligence, you should also conduct a thorough cultural assessment. This can help to identify potential challenges and opportunities and should inform decision-making throughout the integration process.
- *Leadership Alignment*: Make sure you have an open dialogue and collaboration between leaders from both organizations from the start. By doing this, you can align strategic objectives, values, and management styles. Encourage leaders to act as role models for cultural integration and openly communicate the benefits of the merger to employees.
- *Communication and Employee Engagement*: During a merger or acquisition, communication with employees is key. Without it, rumors start, and panic can set in. Develop a robust communication plan that keeps employees informed about integration progress, addresses concerns, and highlights the shared vision and values. Encourage employee participation in cross-functional teams and integration initiatives to foster collaboration and a sense of ownership.
- *Cultural Integration Roadmap*: Create a structured integration plan that outlines specific steps and milestones for cultural integration. This roadmap should include activities such as cultural training, cross-cultural workshops, and initiatives that promote cultural exchange and understanding.

Cultural alignment is essential to successful mergers and acquisitions. Failure to access cultural compatibility and proactively address any potential misalignments can lead to significant issues when it is time to integrate the two companies. However, when there is an emphasis on communication, employee engagement, and leadership alignment, companies can overcome challenges, preserve the strengths of each culture, and create a harmonious and thriving merged entity.

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Reshaping of the Biotech M&A Landscape

While the road ahead might be unpredictable, the core dynamics of the life sciences sector and the coming expiry of patents worth over $100 billion are poised to drive a renaissance in biotech mergers and acquisitions.

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The biotechnology industry has always been marked by innovation, rapid technological advancements and a drive to prevent, treat and cure disease. The prospect of mergers, acquisitions and joint collaboration deals with larger pharmaceutical giants has always served as fuel for the aspirations of small and mid-sized biotechnology companies. So much so, that M&A (mergers and acquisitions) is deeply ingrained in the biotech industry's landscape, and it has been a significant catalyst in driving innovation and growth.

Traditionally, M&A deals in biotech were centered around licensing agreements, where large pharmaceutical conglomerates would seek to build their pipeline of promising drug candidates in various stages of development and bring them to market with their large global sales forces. But today, the landscape has shifted to encompass a broader spectrum of strategies, such as acquiring advanced technologies, data analytics capabilities and innovative platforms that enable personalized medicine and more efficient drug discovery processes.

Although recent years have witnessed a perceptible inertia in M&A activity within the sector, a bright glimmer of change may be on the horizon. A convergence of factors is set to propel the biotech industry into a new era of M&A activity. Could 2024 be the year that finally reshapes the M&A narrative?

The Coming Patent Cliff

In the coming years, many of the blockbuster drugs that dominate treatment for widespread diseases will lose their coveted exclusivity, paving the way for fierce competition from generic and biosimilar alternatives. This heightened competition is a response to the industry's pressing need for cost control.

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In the wake of this impending patent cliff, industry observers are predicting a surge in M&A and market consolidation.

Large pharmaceutical corporations are facing the challenge of maintaining consistent revenue streams. Will they look to shield themselves from the anticipated impact of generic and biosimilar competition, and will they turn to acquisitions as a strategic solution to confront the problem?

The link between patent cliffs and increased M&A activity is well-documented in the pharmaceutical industry. Academic research has repeatedly demonstrated that when pharmaceutical companies confront patent expirations, they tend to seek refuge in M&A deals. For example, AbbVie followed the lessons of the previous patent cliff by merging with Allergan in a 2019 deal.

"A significant number of blockbuster drugs are losing their exclusivity in the next five years, and we expect that generic and biosimilar competition will be particularly fierce and intense due to cost-containment pressures," according to Fitch Solutions. "We expect M&A and market consolidation rates to increase in the short to medium term as pharmaceutical companies turn to acquisitions to maintain a constant revenue stream and protect against the upcoming patent cliff."

Scientific Breakthroughs and Innovation

Recently, large corporations have turned their attention to burgeoning biotech enterprises to fuel their quest for innovation. These transactions are concentrated on domains such as cancer treatment, immune system disorders and rare diseases—areas witnessing remarkable victories in clinical trials, translating into substantial profits for approved treatments.

One of the key drivers behind the evolving M&A landscape in biotech is the continuous stream of scientific breakthroughs and technological advances. The convergence of fields such as genomics, artificial intelligence and precision medicine has led to the emergence of new therapeutic approaches and a deeper understanding of disease biology. Biotech companies are now seeking to capitalize on these advancements through strategic partnerships, collaborations and acquisitions.

For example, the growing emphasis on gene editing technologies like CRISPR-Cas9 has led to several high-profile acquisitions. Companies are vying to secure intellectual property, talent and platforms that enable them to harness the potential of gene editing for therapeutic applications. Similarly, advancements in data science and computational biology have prompted collaborations between biotech firms and technology companies as the industry recognizes the importance of data-driven decision-making in drug development.

Changing Market Dynamics

The evolving dynamics of the healthcare market are also influencing biotech M&A trends. The rise of orphan drugs, which target rare diseases, has created a niche market

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that can be highly lucrative. Consequently, many biotech companies seek to acquire or partner with firms with expertise in rare disease research and development. These targeted acquisitions allow companies to enter specialized markets and address unmet medical needs more effectively.

The COVID-19 pandemic highlighted the importance of vaccine development and infectious disease research. Biotech companies with capabilities in these areas have garnered increased attention from investors and potential acquirers. This shift in focus toward pandemic preparedness and vaccine technology is reshaping the priorities of biotech M&A activities.

The Watchful Eye of Venture Capitalists

Venture capital investors are watching these developments in the biotech M&A landscape closely due to the potential for significant returns on investment. As biotech companies expand their capabilities through strategic partnerships, venture capitalists recognize the opportunities for financial growth and industry disruption.

These investors are also becoming more selective, focusing on companies that offer innovative technologies and promising drug candidates and exhibit a strong management team and a clear strategic vision. Biotech startups that align with the changing dynamics of the industry are more likely to attract the attention of venture capitalists seeking to invest in the next wave of transformative healthcare solutions.

Yet, the path to these strategic acquisitions has not been without its costs. Premiums on biopharma acquisitions have often soared beyond 100%, partly driven by the significant funding biotech companies secured from public markets and private investors. These robust valuations dictated higher monetary offers from potential buyers. The results are high-end deals with staggering price tags. Yet, leading pharma corporations and private equity firms boast sizeable capital reserves awaiting deployment. With patents worth over $100 billion poised to expire by 2030, the imperative for a robust and sustainable pipeline is undeniable.

A Resurgence In M&A Activity

As scientific breakthroughs, changing market dynamics and the demand for personalized medicine reshape the sector, biotech companies are redefining how they approach mergers and acquisitions. Venture capital investors are carefully observing these trends, recognizing the potential for substantial returns on investments and the opportunity to support companies that will shape the future of healthcare. As the biotech landscape continues to evolve, the role of venture capital investors will remain crucial in supporting innovation and driving positive change in the industry.

Despite the uncertainties that linger, the industry-wide emphasis on cultivating strategic pipelines through external innovation—often facilitated by corporate venture investments—sets the stage for a resurgence in M&A activities.

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Key Considerations for Founders Exploring M&A as an Exit Strategy

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For founders considering a merger or acquisition as an exit strategy, finding the right acquirer is crucial, and it just takes one. A successful M&A deal just needs to close. A successful combination and combined business require more than just financial considerations: it demands a strategic fit between the merging entities. In this blog, we explore the most important considerations for founders when assessing whether a potential acquirer aligns strategically with their vision and goals.

1. **Define Your Company's Strategic Objectives**: Before exploring potential acquirers, it is vital to have a clear understanding of your company's strategic objectives. Define your long-term vision, goals, and values. Outline the core competencies, market positioning, and competitive advantages that have driven your success. This self-assessment will serve as a foundation for evaluating potential acquirers.

2. **Evaluate Complementary Capabilities:** Assess the acquiring company's capabilities and determine how they complement your own. Look for areas where their strengths fill gaps in your business, or where their expertise and resources can enhance your offering. Consider whether the combined entity can create synergies that result in a stronger market position and improved competitive advantage.

3. **Assess Market and Industry Alignment:** Evaluate the potential acquirer's market position and industry focus. Consider whether their target markets, customer segments, and distribution channels align with your business. Analyze market trends and future growth opportunities to ensure the acquirer has a solid understanding of your industry and can leverage synergies effectively.

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4. **Cultural Compatibility:** Culture plays a vital role in the success of any merger or acquisition. Assess whether the potential acquirer's corporate culture aligns with your own. Look beyond surface-level values and examine management styles, decision-making processes, and employee engagement practices. Cultural misalignment can lead to integration challenges and hinder the realization of synergies.

5. **Long-term Vision and Alignment:** Consider whether the acquiring company shares a similar long-term vision for the future. Evaluate their strategic plans, growth aspirations, and commitment to innovation. Assess whether their goals align with your own and if the merger or acquisition can provide the necessary resources and support to realize mutual objectives.
6. **Analyze Track Record and Reputation:** Conduct thorough research on the acquiring company's track record in mergers and acquisitions. Assess their history of successful integrations and their reputation within the industry. Look for evidence of previous strategic alignment with acquired companies. This analysis can provide insights into their ability to execute a successful merger and drive post-acquisition growth.

7. **Evaluate Leadership and Management Team:** Assess the acquiring company's leadership team and management capabilities. Consider whether they have the expertise and experience necessary to guide the combined entity. Evaluate their approach to talent management, employee development, and retention. A strong leadership team can help navigate the complexities of integration and ensure a smooth transition.

8. **Consider Financial Stability and Resources:** While strategic fit goes beyond financial considerations, it is still essential to evaluate the acquiring company's financial stability and resources. Assess their financial health, liquidity, and ability to invest in the merged entity's growth. Look for synergies that can optimize costs and drive profitability.

9. **Evaluate the State of Readiness:** Are you ready? Have you audited your financial statements? Should you provide a quality of earnings report to the counterparty? Does the counterparty have audited financial statements or quality of earnings? What are your enterprise reporting and planning systems, and what are those of the counterparty, and how will they be integrated? Who will do what?

A successful business combination requires a careful evaluation of complementary capabilities, cultural compatibility, long-term vision, reputation, leadership, and financial stability. By considering these important factors, founders can increase the chances of a successful transition and set the stage for future growth and success as part of the combined entity.

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How artificial intelligence is disrupting the dealmaking process

Foley & Lardner LLP attorneys Louis Lehot and Eric Chow discuss how artificial intelligence and machine learning are affecting the mergers and acquisitions process and what issues may arise with the use of this emerging technology.

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The use of artificial intelligence (AI) and machine learning (ML) technologies has exploded across the board. According to EY's July 2023 CEO Outlook Pulse,[1] almost half of the CEOs who participated are focusing capital allocation on these technologies, with 43% responding they have already fully integrated AI-driven product or service changes into their capital allocation process and are actively investing in AI-driven innovation.

As more businesses adopt these technologies, it has become clear that there are countless business applications for AI and ML. This includes their ability to transform the merger and acquisition process.

Negotiating a deal and running due diligence in a merger or acquisition has always been complex, time-consuming, and resource intensive. However, AI and ML are changing the game and making the process much more efficient on many levels. These transformative technologies can streamline deal processes with their ability to better analyze data and improve outcomes, particularly regarding due diligence and contract analysis.

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In any transaction, participants exchange long lists of questions, requests, and spreadsheets demanding documents, data, and information, generally referred to as due diligence request lists or DDRLs. This has traditionally been a cumbersome process, involving mass amounts of digital and paper files and teams of bankers, lawyers, accountants, and analysts who must review the documents, glean information, negotiate agreements, produce disclosure schedules, and allocate risks and rewards.

This largely human and manual process of digesting the information could be more efficient, as well as the source of many budgets exceeded, details missed, questions never asked, and opportunities for synergies lost.

However, with the introduction of AI in the dealmaking landscape, the due diligence process is becoming more efficient as it is able to analyze what can be overwhelming amounts of data in a fraction of the time.

Tools like Robotic Process Automation (RPA) can provide tremendous potential for time and cost savings as they automate data analysis and can quickly flag anything that would require further review. AI tools also provide predictive modeling tools, allowing companies to examine various scenarios and what kinds of risks might be involved.

Companies such as Deloitte are launching products to assist with the due diligence process. Their iDeal product uses AI and ML to organize and tag the huge amounts of data involved. It can also learn from corrections made by humans, making it more accurate the more it is used.

Numerous companies are also launching AI products designed to improve the contract review process. Take, for example, Kira Systems, a machine learning contract and document review software that can scan and analyze vast amounts of data sources and contracts. This kind of software allows users to analyze complex contracts and documents with a much higher level of efficiency, saving time and money and allowing for identifying and mitigating risks.

Spellbook, Syntheia, and IronClad are other examples of companies focused more specifically on contract review. While these tools do not replace human judgment and experience, they help significantly speed up what is traditionally a prolonged process and help identify red flags that can turn into major issues down the road.

The use and benefits of AI in transactions go beyond just due diligence and contract review, extending into target identification and valuation — two areas that can often present difficulties.

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Target identification requires extensive research and detailed analysis of, again, what can be mass amounts of data. In order to better match targets and buyers, AI tools can compound numerous data sets to pinpoint patterns that humans cannot otherwise recognize, enhancing the target identification process.

It is important to remember that AI tools do not take into account corporate value compatibilities and visions of the buyer, but they can help narrow down available targets and provide insights. They can also analyze market trends, competitor performances, and customer behavior to identify the impact of a target and a company's most suitable acquisition targets. An essential part of this process is the technology's ability to assess the risks of a transaction or the risk indication of a potential target.

Determining a "fair" valuation can be one of the most difficult parts of the transaction process, but the predictive modeling techniques we discussed earlier can also assess the target's future potential and forecast financial performance more accurately. AI algorithms can analyze historical financial data, market trends, and macroeconomic factors to project potential growth scenarios.

AI also has the capability to analyze thousands of previous valuations and learn from them, putting that knowledge to use in the valuation process. This data-driven valuation approach, combined with the human intuition of dealmakers, helps negotiate better deals and avoid overvaluation or undervaluation of the target company.

Potential issues and concerns

Despite AI's numerous advantages to the deal landscape, as with any new and developing technology, some issues and concerns must be considered.

Data Privacy and Security: Because of the vast amounts of data processed by AI tools, there are real concerns about data privacy and security breaches when used in the deal context. Sensitive and private information is shared throughout a transaction process, and the last thing parties want is for their data to be compromised. Companies should ensure robust data protection measures to prevent unauthorized access and potential misuse of sensitive information.

Lack of Human Judgment: AI lacks human judgment and intuition. It is important to bear in mind that while it is a valuable tool, AI does not make human involvement obsolete or irrelevant, especially when evaluating qualitative factors and understanding the nuances that can impact a deal's success.

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Regulatory Compliance: Relying heavily on AI may inadvertently lead to non-compliance with various regulatory frameworks governing transactions. Similar to the lack of human judgment, some areas of AI technology still need to be fully developed enough to rely on entirely. Compliance requirements may easily be overlooked by AI technology.

AI is an Investment: AI is still in the very early innings, and everyone may not be able to take advantage of it right away. To some organizations, AI means they may have to go out of their way to invest time and money into technology and possibly even personnel. Companies should be mindful of the time and resources required to implement AI tools and carefully weigh the risks and rewards.

AI will undoubtedly continue to transform the way deals are conducted, and companies are already jumping in to launch new tools to automate this process even more. Its potential benefits are vast, enabling people to make more informed and efficient decisions. However, it is vital to strike a balance between leveraging AI capabilities and incorporating human expertise to address serious concerns that exist.

AI is not yet at a place where the technology can replace all human interactions and procedures within a deal, and AI users should be cognizant of the issues and concerns presented above. But with proper safeguards in place, it can serve as a powerful ally in creating more informed and ultimately more successful deals.

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