Situation Assessment Report

Merger and Acquisition Project

OurClient is a high growth software development company; the publicly held company has annual sales of $160 million. OurClient had initiated discussions to acquire—Wxyz—a three-year old, privately held software company with annual sales of $26 million. They were interested in Wxyz for the following reasons.

(1) Key customers of OurClient wanted software capabilities and features added to the product, which OurClient's tech teams could not readily develop within the timeframe expected.
(2) Market research indicated customers expected even more enhancements to the product over the next three years. OurClient knew their existing product could not scale to meet these demands so they would need an entirely new software platform, a costly and somewhat risky undertaking.
(3) One of OurClient's largest competitors had announced a new software product that claimed to include the capabilities and features customers were demanding, posing a major competitive threat.
(4) Wxyz was the only other company with software that included the needed enhancements and that could fill the gap in OurClient's product line. Their product was respected by the market and industry gossip suggested the owners of the privately held company might be open to selling the company.

Because two board members of OurClient had reservations about the proposed acquisition, they asked Outlook Analysis Corporation (OAC) to assess Wxyz and the proposed transaction. The assignment included information discovery and analysis of:

(1) Wxyz's motivations and objectives in selling the company
(2) The integrity of the company's finance reports and revenue
(3) The quality of sales and customer relationships
(4) Hidden agendas of the board of directors, senior management or major shareholders
(5) The existence of any illegal operations
(6) Assessment of Wxyz's software products, basic technology, research and development program
(7) The investment banking firm hired by Wxyz
(8) The backgrounds, strengths and weaknesses of individual members on the negotiating team
(9) Wxyz's likely negotiation strategy and tactics
(10) Existence of any pressure points affecting Wxyz's negotiation strategy
(11) Status of competing potential acquirers
(12) Wxyz's bottom line price, terms and conditions, as well as their flexibility in making trade-offs
(13) Overall advice and recommendations regarding the proposed acquisition and successful negotiation of a transaction.

OAC has performed several hundred M&A assignments over the past twenty years and developed proprietary analytical tools to discover needed information, facts and data. Within five days, the OAC team had discovered the following.

(1) Wxyz's motivations and objectives in selling the company

The motivation to sell the company stemmed from the philosophy of the chairman and president, the two largest shareholders, to sell companies at their peak value. Their view is Wxyz is near the peak and now is the best time to realize its value.

The true motivation to sell was related to problems with Wxyz's technology platform; more on this later.

(2) The integrity of the company's financial reports and revenue

The company's finances, accounting and revenue are solid. The reporting systems and numbers are accurate.

(3) The quality of sales and customer relationships

Sales quality and customer relationships are excellent. The market respects Wxyz's brand name and image. The company's forecast of 60% annual sales growth for the next three years appears to be accurate.

(4) Hidden agendas of the board of directors, senior management or major shareholders

Management has denied OurClient access to the company's software development teams even though our client has been willing to sign non-disclosure agreements. Every employee in the company has received strict instructions not to discuss anything about the company, even minor details or anecdotes, with anyone not employed the company.

This denial of information raised suspicions among OurClient's board of directors and was an important reason in hiring Outlook Analysis.

(5) The existence of any illegal operations

No

(6) Assessment of Wxyz's software products, basic technology, research and development program

The original development team wrote the software several years ago to meet forecast marketplace needs through the end of next year. While they knew customer needs would continue evolving after next year, they did not want to spend the time, money and resources needed to develop that additional scalability. Consequently, it will be necessary to scrap the Wxyz software platform and developed almost from scratch to meet the marketplace needs beyond next year.

Furthermore, the original development team left the company more than a year ago to start a new venture (non-competing). The team had done this develop-and-sell strategy at least once before.

OAC has also discovered that Wxyz management is aware of their software's limitations. They are also aware that OurClient's primary reason for acquiring Wxyz is to acquire technology that can scale to meet marketplace needs three years from now. So Wxyz does not intend to reveal the software's limitations. Their aim is to take the money and run.

(7) Information about the investment banking firm hired by Wxyz

While management has retained a small investment bank as an adviser, management is actually conducting the M&A negotiations. People who know the management team would say they are highly confident they can negotiate the best transaction possible without heavy investment banker participation.

Most people consider the banking firm competent in handling transactions of $50 million or less. People who know them would say their ethics and trustworthiness are good, though everything must be in writing.

(8) The backgrounds, strengths and weaknesses of individual members on the negotiating team

Wxyz's negotiating team is comprised of the chairman of the board, president and chief executive officer, chief financial officer, and vice president of marketing. The chairman and president are the two largest shareholders in the privately held company. They have full approval from the board of directors to make all decisions related to completing the sale of the company.

Inside and outside the software company, the chairman and president are known to be excellent bluffers and as a result are successful in negotiating better than expected agreements. Management's confidence in its own negotiating abilities is the reason for undertaking the negotiations themselves and relegating the investment bankers to a support role.

The chief financial officer and vice president of marketing serve in a supporting role to the chairman and president in the negotiations. The same applies to the company's legal and accounting firms.

Chairman and President

People who know the chairman and the president say the two men think and act as one person. They are known to finish each other's sentences. It is unusual for them to disagree.

The chairman and the president are confident by nature, forceful in negotiations, and are intimidating when allowed. They will fight rather than compromise. Intimidation best describes their attitude and style.

When they confront solid opposition or find themselves on shaky ground, they usually attempt to obscure the obvious, switch to macro from micro, and obfuscate facts and solid arguments by trying to shift focus to unrelated minutiae.

The Chairman and the President are typically in-your-face argumentative. They negotiate to win it all as opposed to friendly negotiations and comprise. People who have negotiated with them say there is no consideration of compromise or fair value. Exploitation is their focus and goal.

One strategy has been successful in negotiating with them in the past. The strategy is to add qualifications and contingencies with penalties to every point they want. The strategy has led them to comprise key issues.

Chief Financial Officer

The chief financial officer (CFO) performs well in his job, however, he lacks leadership and negotiating skills. He can best be described as an efficient bean counter. His purpose in the M&A negotiation is to support the chairman and president with facts and data.

He is only slightly aware of the software's flaws, but prefers to avoid any knowledge in order to distance himself from any improprieties. He is loyal to whoever pays his salary. He lacks strength of character.

Vice President of Marketing

The vice president of marketing and sales has earned a good track record during his two and a half years with the company and in previous positions with other companies. He knows the company's marketplace and is good at recognizing and exploiting opportunities.

While he is ready to seek another position, the president has convinced him to stay until the company is sold. His decision on whether to stay with the new corporation depends on the same factors he would weigh in accepting another position. He is unaware of the software platform's limitations.

The vice president of marketing has basic integrity. When he makes a commitment, he honors it.

His role in the negotiating team is strictly to support the chairman and president with information, facts and data about the marketplace and the company's accomplishments.

(9) Wxyz's negotiation strategy and tactics

Wxyz's negotiating team's strategy is to focus on:

a. Customers' demand for OurClient's software to include Wyxz's capabilities, features and benefits. From industry gossip and previous discussions with OurClient personnel, the Wxyz negotiating team knows OurClient has an almost desperate need to acquire their software technology.

b. Wxyz's software fit into OurClient's product line, and

c. The accuracy of Wxyz's financial statements as a way of diverting attention from the undisclosed scalability problems with its software.

Wxyz has placed a limit on the time for negotiations to inhibit OurClient's technology team from fully analyzing the software. This is why management has delayed contact between OurClient's technical team and Wxyz's developers and engineers. They couch the delays with excuses that OurClient could steal the core technology, if allowed to interface with the developers and engineers, even if OurClient signs non-disclosure agreements.

(10) <u>The existence of any pressure points affecting Wxyz's negotiation strategy</u>

Wxyz needs to complete the transaction before OurClient discovers the truth about the software limitations.

They are aware of OurClient's need for their software.

They have studied OurClient's management team, negotiating style and have conducted research on a smaller scale on OurClient's investment banker.

(11) <u>Status of competing acquirers</u>

Although management has alluded to serious interest and discussions with one of OurClient's competitors, OAC has not found any evidence of a competitor in this transaction.

(12) <u>What are Wxyz's bottom line price, terms and conditions, as well as their flexibility in making trade-offs?</u>

Although Wxyz is seeking an all cash deal of $45 million for the sale of the company, the largest shareholders and board members have agreed among themselves to accept a minimum of $36 million in cash and stock, which includes $5 million to retire debt.

Because the OurClient's stock has a history of volatility, Wxyz's strategy is to have the acquirer pay a 25% premium for each share of stock used in the transaction instead of cash. Thus, if the acquiring company paid $45 million of the transaction price in stock, the 25% premium would raise the transaction price to $56,250,000. If OurClient agrees to pay half the transaction price in cash and half in equity, management would be willing to reduce the 25% premium to 20%. It is worthwhile noting that securities analysts are bullish on OurClient's stock.

The Wxyz negotiating team will want any stock included in the transaction to be without restrictions because they plan to sell quickly after the close. OurClient can use this obsession to reduce or eliminate the premium Wxyz will demand.

(13) <u>OAC's recommendations regarding the proposed acquisition and advice on negotiating a transaction</u>

OAC's advice and recommendation is OurClient should not acquire Wxyz. Our reasons are listed below.

a. Wxyz management lacks of integrity and this will eventually negate any gains achieved through the acquisition
b. The minimum price, terms and conditions that Wxyz management will accept are too excessive for serious consideration, particularly given Wxyz's limited technology and position in its marketplace.
c. The software platform will not meet OurClient's needs.
d. OurClient should use an unrelated intermediary to contact the original software development team to explore their willingness to re-develop the software to meet OurClient's needs.
e. Simultaneously, OurClient should use an unrelated intermediary to contact other software platform developers to explore a development contract.
f. OurClient should refocus negotiations with Wxyz to license the software on a one-year basis or less, depending on the realistically estimated time for the scalable software to be developed and ready for shipment to customers. An alternative is create a joint venture to bundle the Wxyz software with OurClient's software,

OAC also recommends that current negotiations be continued in order to avoid alerting Wxyz management that OurClient is changing strategic directions to solve its scalable software needs.

Since Wxyz rejected OurClient's request to sign a non-disclosure agreement in order to meet Wxyz's technical staff, it is highly recommended OurClient avoid signing any non-disclosure agreement of any kind.

OAC can provide additional information discovery and outlook analysis on software developers OurClient considers capable of developing the scalable software as well as all negotiations with Wxyz.

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