Stiernberg Consulting White Paper
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Understanding M&A and Strategic Alliances

Dynamics of Mergers, Acquisitions, and Strategic Alliances in Our Industry

I. Overview

More than ever, companies in our industry are thinking through their options for mergers, acquisitions, and strategic alliances. There are many examples of industry consolidation (mergers and acquisitions), some successful, some not. There are even more examples of successful alliances and partnerships in which the participating companies retain their unique identities and work together toward a common business objective.

The temptation to sell a company—in troubled times or otherwise—is real and often compelling. Sometimes a "fire sale" liquidation is the only alternative. The industry experienced a lot of this during the 2009 to 2010 time frame. Things started to rebound in 2011, and cooler heads largely prevailed. More time was spent on due diligence. Valuations, while lower than many sellers were asking, were a bit saner than in the go-go 1999 to 2006 era.

So what is a company to do that wants to buy or sell in 2013 and beyond? Are there steps to take to prepare a company for a merger or acquisition? Are there alternatives? Would a strategic alliance be better than an outright sale? What do all those buzzwords really mean, especially in an industry with relatively few public companies?

This white paper defines the terms, debunks the myths, delineates the critical success factors, and offers six actionable suggestions for things that you can do to optimize your company's strategy for mergers, acquisitions, and strategic alliances.

II. Definition of Key Terms and Types of Alliances

First let's define key terms and concepts.

- **Merger.** Two or more companies agree to combine all assets and activities on the business level to form a new company with its own new identity.

- **Acquisition.** One company purchases the stock or assets of another. The buyer may or may not retain the identity of the acquired company.

- **Strategic Alliance.** A business relationship among two or more companies in which the participants agree to work together toward a shared objective without exchanging shares of ownership. The parties also retain their respective identities.

  Here are six applications for strategic alliances:

Type of Alliance	Industry Example
Co-Development of Products	Manufacturers, engineering firms, and ODMs organized to commercialize and manufacture products
Co-Marketing of Products	Non-competitive manufacturers organized to provide market education and system demonstrations to build sales
Buying Groups	Dealers organized to create purchasing and promotional leverage with multiple vendors
Sharing Groups	Dealers or multi-line rep firms organized to share best practices and use business networking to optimize revenue and profits
Standards Development Groups	Manufacturers, specifiers, dealers, and end-users organized to define technical standards and protocols
Legal and Regulatory Advocacy Groups	Trade associations and their stakeholders organized to influence legislation that has an impact on commerce or technology

While mergers and acquisitions are designed to be permanent, strategic alliances may be short-term or long-term depending on the situation. For further clarity, the following are not strategic alliances.

- Basic dealer agreements in which a vendor authorizes a channel partner to purchase goods for resale.
- Most relationships between manufacturers and their OEM vendors, especially related to purchase of commodity parts, sub-assemblies, or finished goods.
- Most relationships between independent multi-line reps and the vendors that they represent. The customary “30-day clause” (in which a vendor can terminate the rep on 30-day notice, with or without cause) exemplifies this.

III. Reasons for Developing an M&A (Merger and Acquisition) Strategy

The motivations of buyers and sellers are different. When they converge (albeit from different perspectives), the result can be a win-win scenario. Here are examples of reasons that a company would develop an M&A or alliance strategy.

There are many permutations of the following buyer/seller motivations. Which ones can you relate to most?

Buyer (Acquirer) Motivations:

- The company can become more important to the market (e.g. offer more components of a whole system) through the addition of additional products (goods or services).
- The company can enter a new market. This includes both end-user markets and geographic territories.
- The company can develop a new channel of distribution. A common example in our industry is manufacturers that focus on retail and direct marketer channels getting into installation and integration through system contractors and AV integrators.
- System synergy with existing products. An acquisition can accelerate the buyer's entry into new product and application categories.
- IP or internal systems that would modernize or enhance their existing knowledge. The acquired company may have an attractive patent portfolio or advanced CRM system that would make it attractive beyond its products and existing channel relationships.
- Executive and engineering talent. Sometimes the buyer is looking for people to drive its long-term growth strategy and recognizes key individuals or teams within the acquisition target. This is especially true in software-related facets of our industry.
- Achieve growth that exceeds general industry economic outlook trends. With some notable product category and regional territory exceptions, our industry is growing relatively slowly (single-digit CAGR %'s over the next three years). Some buyers want to build business faster, and not take the risks associated with investing in organic growth.
- Build sales and profits to get ready for its own ultimate sale. In a few cases, the buyer needs to build critical mass quickly before it can create a suitable "liquidity event" for its stakeholders.

Seller Motivations:

- Desire for long-term legacy that ensures continuity beyond the founders viable contribution. The seller may be motivated to see its brand live on and its people taken care of after they retire or move on.
- Grow with the benefit of stronger financial resources. This is a very common scenario in which the seller has bootstrapped itself for years and needs a shot of cash to grow to the next level.
- Expand their market or channel reach. This is the converse of the buyer motivation described above: the seller needs to grow quickly into a new market or distribution channel, but lacks the resources to do it organically.
- Enhance their brand. In this scenario, the seller has viable technology and products but lacks the brand positioning or channel penetration necessary to optimize sales and profits.
- Sell off a division that doesn't fit with the company's overall direction. Mid-sized companies are often faced with the challenge of "pruning" in order to stabilize or grow core business.

- Time to cash out. The seller's motivation is part financial (pay off debts, build a secure retirement) and part lifestyle (more time with family, pursue other interests, deal with health issues). Our industry is replete with owner-founders who are 1) still active in the business, 2) do not have a succession plan, 3) are at or nearing legal retirement age, and 4) could use a breather anyway.

IV. Six Common Myths

Alliances, mergers, and acquisitions are in the news all the time—both industry trade publications and the general media. Why? Because business news gets attention (and helps sell advertising). It's also a bit glamorous to talk about strategy and deals akin to the old "one that got away" fish stories or urban legends. Here are six myths and realities.

Myth #1: Every company is for sale.

Reality: Some properties (companies, patent portfolios, etc.) are just not for sale. This is largely a function of our industry being predominantly private vs. public companies. The motivation of many owners has more to do with creativity and leaving a legacy than optimizing shareholder wealth.

Myth #2: Financial investors are heartless vultures.

Reality: The majority of angels, VC's and equity investors are real people with positive values. The unfortunate stereotype derives from the well-publicized "slash and burn" stories of investment groups taking over, sending jobs overseas, closing offices and factories, laying off core staff, and more—all in the name of optimizing profits. In most cases, financial buyers will not purchase a company unless they understand its value and share its vision.

Myth #3: "Entertainment Business" is an oxymoron.

Reality: Many companies in our industry operate using business principles and methods that are unconventional in the eyes of "big business"—especially financial investors. Despite this, the global entertainment technology, music products, and AV systems industries represent tens of billions of dollars in annual revenue. It is largely stable and profitable, and has a bright future.

Myth #4: All startups lead to IPO's (Initial Public Offerings).

Reality: There are ~ 63,000 publicly traded companies in the world, with ~ 15,000 of those headquartered in the United States (Source: Bloomberg LP). This is a small fraction of the millions of private companies. Far more startups end up in private hands (sole proprietors, partnerships, LLC's, and equity-backed corporations) than "go public." In our relatively small and fragmented industry, the legal and regulatory requirements alone are enough to discourage IPO's in the majority of instances.

Myth #5: Intangible assets have no value.

Reality: With the barriers to entry in our industry getting lower every year, intangible assets like proprietary technology, fine-tuned processes, established vendor and channel relationships, brand positioning, and executive teams have taken on greater meaning and higher value. These are critically important elements of strategic alliances in that the alliance partners must bring complementary assets to the business relationship in order for it to be successful.

Myth #6: The boss is never going to quit (or sell).

Reality: Many entrepreneurs in our industry love what they do and indeed do not plan to quit or sell. However, things change. Too many owners lack a viable exit strategy, and that factor de-values the company. What happens if the boss gets sick or dies unexpectedly? What if an irresistible offer comes along? Beware of the "never" assumption, especially in today's dynamic world.

V. Ten Industry Dynamics That Drive Strategic Alliances

Strategic alliances are potentially viable alternatives to 1) maintaining the status quo and 2) mergers or acquisitions. Here are ten dynamics of our industry that make it conducive to alliances.

1. Lots of small-to-medium sized companies that want to grow. While a small company may not be ready to sell or merge, it may have substantial assets to contribute to an alliance.

2. Fast rate of technology change. Hiring engineers to focus on internal product development may take too long vs. an alliance-related alternative.

3. Too small for most financial investors. Apple's 2011 EBITDA (~ $36 billion) is greater than the gross revenue of much of our extended industry. And that's one brand, not hundreds. Our industry needs to cooperate and collaborate for growth, not look to investors for an exit strategy.

4. The "tattoo and piercing" factor. This is another turnoff for many "straight" investors. While they love music, movies, games, and entertainment as individuals, they have a hard time convincing their stakeholders to put money into creative projects or companies.

5. Surprising number of startups. Despite the sluggish economy and turbulent global socio-political climate, there is a steady stream of self-financed startups. These companies often "partner" with established firms in order to innovate and grow.

6. Changing field salesforce models. While some manufacturers are firing independent multi-line rep firms (“reps”), others are hiring reps and/or building hybrid field salesforces. The decline of the “30-day mentality” is fostering alliances among vendors and outsourced sales organizations worldwide.

7. Changing role of two-step distributors and channel management firms. Technology-driven manufacturers continue to turn to channel managers as an alternative to handling their own sales, marketing, and distribution logistics. Channel management alliances may also be viable for established brands that want to diversify or experiment in either new channels or new geographic territories.

8. Competing with emerging channels. How do independent CE, AV, and MI dealers compete with the likes of amazon.com or Wal-Mart? Buying and sharing group alliances have taken on enhanced meaning and relevance to dealers, reps, and branded manufacturers.

9. Competing with low-cost producers. The down-market “race to the bottom” has heightened the industry’s consciousness about the cost of everything from parts, labor, and finished goods to outsourced sales, marketing, and technical service expenses. There is leverage in volume, and alliances are tools for leverage.

10. Increasing importance of brand identity. Iconic brands got that way for good reason. The companies are often the best run with the best products and best practices. An alliance that includes a strong brand helps all the partners. Examples range from partnering with channel managers and distributors to participation in lobbying and standards-setting groups.

VI. Six Critical Success Factors for Successful Alliances

Here are six action items to consider as you plan for mergers, acquisitions, and strategic alliances. These critical success factors apply equally in the pro/commercial and consumer/residential AV/IT/MI markets.

1. Have a plan. Too many mergers, acquisitions, and alliances are opportunistic and end badly. Know what you want to accomplish and consider alternatives before going to market as either a buyer or seller.

2. Know how all parties measure success. When there is goal congruity, it’s a beautiful thing. If (for example) one alliance partner is interested in revenue growth and another in cost cutting, the conflicting goals and objectives are likely to lead to disaster.

3. Get buy-in from all key stakeholders. Sometimes non-owner executives leap ahead without the owners’ consensus and signoff. Be sure that the project or deal is within your limits of authority.

4. Know who is responsible for doing the follow up work. Appoint an alliance manager or point person for any program. While that person may not have total authority, at least all parties know who is responsible for getting things done.

5. Keep an objective perspective. Is the market big enough to support another player in a new product category? How fast is technology changing? Can we use our brand equity and resources to grow in new areas, or are the entrenched competitors too strong? Understand and monitor how much things cost, how long things take, and what the upside and downside potentials are on a continuous basis, then make adjustments accordingly.

6. Have a contingency plan. What if the deal falls through or the alliance never gets off the ground? Is there a kill switch? Know in advance what the options are and how you will handle them if things don't turn out as originally planned.

A Final Thought

While strategic alliances are not new, they have been under-used in our industry. While many mergers and acquisitions turn out well, others end in disappointment that could have been prevented through better planning and management. Our industry is changing rapidly and growing slowly—the right combination for successful mergers, acquisitions, and alliances, now and in the years ahead.

About This Series

Stiernberg Consulting monitors market conditions, talks with industry stakeholders, and identifies trends and issues on a continuous basis. Our White Paper Series brings the results of these efforts to the industry. Topics range from market dynamics to best practices. All white papers are offered free of charge.

About Stiernberg Consulting

Founded in 1993, Stiernberg Consulting provides business development services in three primary areas: Planning, Market Intelligence, and M&A advisory work. We offer targeted programs and custom services geared to business growth and the development of results-oriented action plans. We serve the multi-faceted entertainment technology, music products, and AV systems industry worldwide. Please visit http://www.stiernberg.com for complete details.

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