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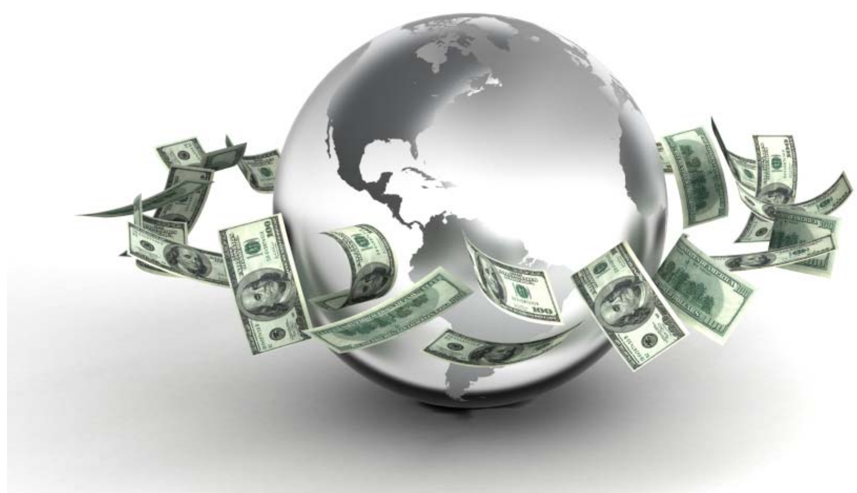
Navigating the Treacherous Path of Mergers and Acquisitions



May 2, 2012

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FOLEY & LARDNER LLP

Overview of the Current M&A Environment

Global M&A Transactions

Year	Number of Transactions	Value Trillion
2007	44,398	$3.70
2008	42,531	$2.29
2009	34,390	$1.87
2010	43,523	$2.35
2011	42,713	$2.53

Overview of the Current M&A Environment (cont.)

Notable M&A Transactions 2011

Buyer	Seller	Value
AT&T	T-Mobile	$39b
Google	Motorola Mobility	$12.5b
HP	Autonomy	$10.2b
Microsoft	Skype	$8.5b
Intel	McAfee	$7.7b
Texas Instruments	National Semiconductor	$6.07b
Applied Materials	Varian Semi	$4.75b
Apple, MicroSoft, Ericsson	Nortel IP	$4.5b
Western Digital	Hitachi hard drive div.	$4.3b

Middle Market Transactions 2011 (Value less than 500 million)

- In 2011 there were $184.44 billion in middle market M&A transactions in the U.S.
- In 2010 there were $174 billion in middle market M&A transactions in the U.S.
- The amount in 2010 was approximately 2X the amount of 2009.
- However, the amount was 35% less than the value of the transactions in 2007.

Key Trends 2012

- Large companies have a war chest of $2 Trillion in cash.
  - Over 1/3 of the respondents to a recent study expected to close an M&A deal in 2012 (Ernst & Young).
- Private Equity is back – PE firms are sitting on $400-$450 billion in capital aimed at acquisitions. With leverage of 2-3X, this means $1.5 trillion is sitting on the sidelines waiting for deals.
  - PE is driven by the debt markets. 2011 saw the stabilization of the US debt markets including a resurgence of high yield debt and middle market loan syndication.

Key Trends 2012 (cont.)

  - PE transaction volume increased in every quarter in 2011 (317 deals, 19% more than 2010, value $33 billion, 67% above the $19.7 billion of 2010).
- 2012 may be a “perfect storm” for Tech M&A.
  - Tax changes – capital gains rate expected to rise in 2013.
  - Industry consolidation.
  - More buyers.
  - Record cash reserves.
  - Trends in disruptive technologies.

Key Trends 2012 (cont.)

- Smaller M&A deals dominate – Although there are big deals closing, large companies realize that their organic innovation is too slow to stay at the top of the market. Some commentators believe that there has also been a shift in preference toward smaller, “bolt-on”, niche transactions and away from large transformative acquisitions.
- Steadily improving US economy will likely eliminate the fear and paralysis that has held many buyers back.

Key Trends 2012 (cont.)

- Pace of technological progress – The need for upgrading technology in manufacturing and service industries is strong. Companies that do not successfully deploy new technologies will fall behind and fail. Those that do, face the high cost, short term disruption and associated risk. The sale of the company may be the best alternative.

Valuations

- Continuing imbalance between buyer demand and the supply of quality target companies.
- Buyers are paying historically high multiples for good companies.
- Most strategic buyers expect valuations to remain at current levels for at least the next six months (Ernst & Young).
- The average multiple for middle market transactions is 5.8X EBITDA.

Valuations (cont.)

- For transactions over $100 million in value, the multiple is 7.5X EBITDA.
- For transactions between $10 and $25 million in value, the multiple is 5.2X EBITDA.

Preparing the Business for Sale

- Remove assets which seller wishes to retain or which may be objectionable to the buyer including condominiums or vacation homes, automobiles or other company owned items;
- Ensure that the financial and corporate records are in good order;
- Seller should have up-to-date minutes of the meetings of the board of directors and a validly elected board of directors;

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Preparing the Business for Sale (cont.)

- Settle lawsuits or terminate unfavorable contracts before the seller's adversaries see the potential sale as added leverage;
- Thoroughly clean and organize the premises;
- Ensure that all shares of stock required to be issued have been issued and that all verbal agreements regarding future ownership are either honored or terminated in writing;
- Develop a comprehensive list of all of seller's assets;
- Create a list of all necessary governmental permits;

Preparing the Business for Sale (cont.)

- Document all loans to or from shareholders and employees;
- Review the development of the company's technology to determine that no others have any ownership rights;
- Compiling a list of the company's patents, trademarks and copyrights;
- Compile information regarding the company's product and/or service warranties and warranty claims; and
- Compile information regarding the presence, use, storage and disposal of hazardous materials.

Letters of Intent

- Determine if the parties can agree on the structure and business points of a transaction prior to spending substantial amounts of time, energy and money conducting due diligence and preparing formal documentation.
- Provide a summary of the proposed business arrangement;
- Fix a timetable for completing the transaction (which can be particularly helpful in complex transactions);

Letters of Intent (cont.)

- Identify the various contracts included in the transaction such as employment or consulting agreements, license agreements or severance arrangements; and
- Identify conditions to closing the transaction such as obtaining financing and buyers due diligence review.
- Measure of commitment.
- Psychological effect on future negotiations.

Enforceability of Letter of Intent

- Under California law, the parties are bound by a letter of intent if they intend to be bound.
- <u>Texaco Inc. v. Pennzoil</u> - The court upheld a jury verdict of $10 billion against Texaco. A short description of this case illustrates the pitfall of neglecting this issue.

Key Issues in Letters of Intent

- Price
- Structure
- Target Closing
- Employees
- Confidentiality
- Exclusivity

Due Diligence

- Financial
- Tax
- Legal
- Human Resources
- Intellectual Property
- Environmental
- Other

Deal Structures

- Asset Purchase
- Stock Purchase
- Merger

Challenging Issues

- Consideration
  - Cash
  - Notes- seller financing
  - Stock
  - Earnout – Appear in 38% of deals
    - Metrics
    - 37% - Revenue
    - 32% - EBITDA
    - 26% - Other
    - Time Period – 60% range from 12-36 months

Challenging Issues (cont.)

- Representations - 23% qualified by Actual knowledge, 73%- Constructive Knowledge (68% in 2008, 61% in 2006)
- Indemnification
  - Triggering events – breach of representations, failure of performance
  - Basket
    - 59% - Deductible approach
    - 31% - First dollar
    - 10% - Other

Challenging Issues (cont.)

- Basket as a percentage of the deal value
  - 47% - 1-2%
  - 41% - .05% or less
  - 12% - greater than 2%
- Cap on Indemnity – 93% of deals have a cap on indemnity
- Cap amounts as a percentage of deal value
  - 43% - Less than 10%
  - 17% - 10-15%
  - 14% - 10%
  - 14% - 15-25%
    - 9% - Purchase price
    - 4% - 25-50%

Challenging Issues (cont.)

- Survival
  - 34% - 18 months
  - 25% - 12 months
  - 15% - Other
  - 14% - 12-18 months
  - 12% - 24 months
- Escrow-Holdbacks – 86% of deals provide for escrows/holdbacks

Challenging Issues (cont.)

– Holdback as a percentage of deal value
  - 24% - 10-15%
  - 24% - 7-10%
  - 16% - 5-7%
  - 10% - 10%
  - 7% - 3% or less
  - 7% - 3-5%
  - 6% - 15-20%
  - 3% - 5%
  - 1% - 20-25%

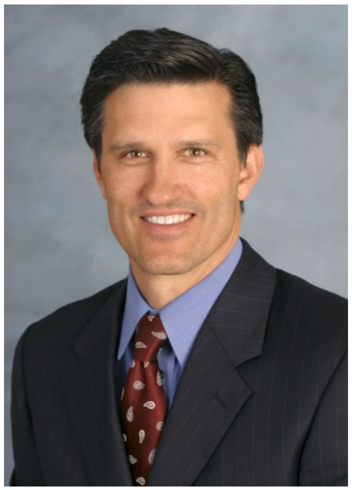
Common Mistakes Made by Sellers

- Sellers fail to prepare themselves for the time and emotional commitment required
- Sellers fail to adequately prepare the business for sale
- Sellers treat buyers as friends
- Sellers convince themselves that the transaction is completed when it has only just begun
- Sellers fail to develop a negotiation strategy prior to beginning negotiations

Common Mistakes Made by Sellers (cont.)

- Sellers believe that buyer’s attorneys are acting independently
- Sellers are not prepared for due diligence and respond poorly
- Sellers work on joint projects with the buyer prior to closing
- Sellers run out of cash during the negotiations
- Sellers cut corners

James C. Chapman



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Jim is a corporate and securities lawyer focusing on start-up and emerging publicly traded and privately held companies looking to expand domestically and internationally and the venture capitalists, private equity groups and angels that invest in them.

He has been involved in approximately 250 mergers, acquisitions and finance transactions and is the author of approximately 40 articles and has given over 50 presentations in the last four years on issues related to raising venture capital, mergers and acquisitions, start-ups, doing business in China and other topics.

Jim has been recognized by *Law 500* as one of the best lawyers in the U.S. for mergers and acquisitions and was named one of the Top 25 Clean Tech Lawyers in California in 2011 by the *Daily Journal*.

Navigating the Treacherous Path of M&A

May 2, 2012

Presenter: Sid Faulkner, CFO

CIRANOVA

M&A Transaction Overview

- An M&A transaction will have
  - Negotiations
  - Due diligence
  - Plenty of work
  - An emotional element
- Each process may be different
  - Different people – large group, small group
  - Organized, disorganized
  - Get it done vs. find something wrong and get a better price
  - Experienced, unexperienced

Timeline

- Find buyer or buyers
  - Everyone wants an "auction", except buyers
- Negotiate and sign term sheet
- Start to create detailed documents
- Detailed due diligence takes place
  - Big group/little group
  - M&A group/implementation group
- Terms modified as needed
  - "Devil is in the details"
- Sign documents
- Close
- Term sheet to close – 3 weeks to 6 months
- And all of this is done quietly while running your business as normal…

Where it starts - The Term Sheet

- Price
  - Earn-outs
  - Liquidation preferences
  - Carve-outs
- When the offer expires – what happens?
- No shop
- Escrow and indemnity
  - These two are subject to change and are KEY negotiation points
- How the term sheet translates into the final documents is very important
  - Try hard to keep documents reflecting the term sheet
  - Avoid "We won the term sheet, they won the documents"

Did I mention Due Diligence?

- Financial – focus on liabilities as well as assets
- Legal – hidden liabilities and other issues
  - Real or imagined
- HR - Invention agreements, terminations
- IP – who really owns the family jewels?
- Customer Due Diligence – 3rd party verifications
- All policies reviewed for correctness and compliance
- The Disclosure Document
  - It's all written down here (or should be)
- The "Data Room" – what this is

Accounting

- Value of your audit
  - Role of your auditors and tax advisors
- Balance Sheet Review
  - Assets
    - You may not have many assets to start with
    - Collection issues?
    - Inventory?
  - Liabilities
    - Accruals
    - Items not accrued
    - Off balance sheet items – lease commitments, etc.
    - Focus on pay related items
    - Deferred revenue?

Accounting (continued)

- Equity
  - Options
  - Financing rounds – schedule of exceptions
  - Expired NSO's
  - When the deal is underway it gets harder to clean up
  - Anything and everything
- Revenues
  - Starts with Rev Rec Policy
  - Contracts – get organized NOW
  - Licenses, PO's, invoices, rev rec decision documented
  - Do payout pro-forma early

Accounting (continued)

- Revenues (continued)
  - Reserves and returns
  - Support and warranty commitments
- You may be asked for fast, up to date financials as of the Close
  - Sometimes given 1-2 days, proforma (as of "next Tuesday")
  - CFO may have to certify them as correct

Tax Issues

- This can be a huge issue
- Filings must be on time and CORRECT
- Filings may be “done” but not correctly and you may not hear from FTB or IRS
- Are 5500’s filed? Really filed?
- International offices?
  - Intercompany contracts in place?

HR Issues

- Confidentiality and inventions agreements
  - For everyone plus contractors – no exceptions
- Terminations
- Release agreements
- Any legal issues
- People on COBRA
- All offer letters and employment agreements
- If anyone or anything will come out of the woodwork – it will be if they hear of a deal
- Retention issues
  - Option plan – vesting, etc.

Intellectual Property

- Since this may be why they are buying you – this gets lots of focus
- Inventions agreements for all – exceptions to standard agreement get attention
- History of your IP – who invented it?
- What have you licensed and included in your product (in-bound IP)?
- What have you licensed to others and how can they use it (outbound IP)?
- Foreign design houses used? Contracts in place?

Legal Issues

- Articles of Incorporation
- All filings
- Review of all Bylaws
- Review of all board minutes (careful what you put in them)
- Litigation
- Patents and Trademarks
- Foreign offices (WOFE's, etc.) – relationship contracts in place?
- Contract reviews – all reviewed with liability and exposure in mind
- Reps and warranties
- Other key documents that need to be created to close
- Who signs for company
- Shareholder approvals
- The Hart-Scott-Rodino Antitrust Improvement Act of 1976, as amended (HSR)

What Happens When Issues Arise from Due Diligence?

- Can they be remedied?
- Are they worth worrying about?
- Are they show stoppers?
- They can affect Indemnity, Escrow, and Price
- *Every start-up has something that didn't go quite right*
- *Most startups hired CFO/Controller long after they were underway*
- If the acquiring company does lots of deals they will have seen everything

The Close

- Lucky if this happens as scheduled
- All issues resolved
  - Escrow, indemnity, loose ends
- Lawyers "happy" – what each can live with
- Standup phone call with all parties
- Congratulations – time to celebrate

Purchase Accounting – Acquiring company book entries

- Valuation of assets
- Treatment of reserves
- In process R&D
- Tax loss carryovers, R&D credits, etc.

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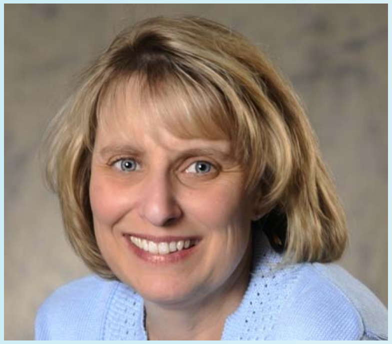

Carol Wagner, CPA, Principal
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Carol is the in charge Principal of the ASL Audit & Accounting and Technology Groups. She has over 20 years of audit and accounting experience, and has held financial positions in various industries, including technology and real estate. Carol serves a diverse group of clients ranging from venture-backed technology companies to manufacturing companies.

In Carol's technology emphasis, she functions as either the engagement partner or the technical review partner. The clients she services includes software, hardware, medical device, and telecommunication companies with domestic and international operations. The financial reporting needs of her clients are complex and unique, requiring extensive knowledge of both individual industry practices as well as complex and ever-changing accounting pronouncements.

Her background also includes work with the Big Four and other accounting firms focused on closely held businesses.

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Q & A Session