The hybrid M&A deal

As Dean Foods demonstrates, this is a compelling way to obtain new technology and products with minimal capital risk.

BY DAVID KAUPPI

No risk, no reward is one of the oldest adages in business. This formulation of strategic risk was first expressed in written form by the Greek scholar Herodotus in 450 B.C.

In the realm of corporate mergers and acquisitions, the challenge for many companies is to obtain a highly desirable product or technology while risking as little capital as possible.

While growth through M&A continues to be a highly popular strategy, many CEOs and CFOs remain wary about making deals. In a recent survey of large corporation executives by Accenture, 45 percent reported their most recent deal failed to deliver all of the expected results.

One solution to traditional outright purchases is the hybrid M&A model. It is becoming increasingly popular.

In a hybrid M&A deal, a large public corporation takes a stake (typically 10-50 percent) in a smaller company (public or private). Generally, this equity infusion comes with a call option, a right to purchase the entire company at a later date at contracted valuation metrics.

The hybrid model has been successfully implemented by Cisco Systems, which began using it more than a decade ago. Between 1993 and 2007, Cisco made 119 acquisitions, many of them in start-ups or small companies with limited track records.

There are three key benefits for the equity parent in the hybrid model:

- Diversified investments minimize overall risk.
- Access to new technologies and products is obtained at minimal cost.
- Managed resources are not dissipated.

For example, a corporation willing to spend $250 million could invest it in an outright purchase of one established company or take a dozen $5 million to $25 million stakes in start-ups.

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In the consumer products sector, we can look to Dean Foods, the leading U.S. provider of fluid milk and dairy products, for an example of a very successful hybrid acquisition.

Supermarket shoppers know Dean Foods through its many local brands, including Borden, Pet, Country Fresh, Meadow Gold and Horizon organic.

One of Dean's most successful acquisitions was White Wave, an organic foods company. It was founded in 1976 by Steve Demos, an organic foods pioneer. He introduced Silk soy milk in 1996, just as the organic foods boom was beginning. In 1999, Dean Foods purchased a 25 percent stake for $5 million. Helped by Dean's "smart money," sales soared to more than $250 million in 2004, when Dean purchased the remaining 75 percent of White Wave for $224 million.

Dean, acting in the Cisco tradition, left entrepreneur Demos and his management team in place and let the company operate with great autonomy. The result was a win-win outcome. By 2005, Dean Foods had more than $10.8 billion in revenue and was bigger than Kellogg and H.J. Heinz.

With successes like this, it may seem surprising we don't see more hybrid deals. The reality is the hybrid concept faces points of resistance on both the seller and buyer side.

Obtaining an investment from a venture capital firm has great allure to entrepreneurs. Many believe that getting VC money signifies they have made it to the "big leagues." What they often overlook are the long odds.

According to Jim Casparie, founder and CEO of the Venture Alliance, the odds of a first-time entrepreneur obtaining venture funding are less than 3 percent. He reports that in 2005, out of 125,000 interested parties making pitches to VC firms, just 2,939 received funding. The average amount worked out to $7.4 million.

When an entrepreneur does catch the eye of a VC firm, he may face punishing valuations, high expenses, and time-consuming reviews by multiple parties.

On the buyer side, resistance to hybrid mergers comes from the traditional culture found in many corporations that equates "ownership" with 100 percent control and a centralized, top-down decision-making process.

However, more and more corporations are coming to understand that in the accelerated world of 21st-century business competition, it is critical to diversify product development by investing in multiple projects. They are also seeing the advantage of fostering an entrepreneurial spirit within the larger corporate structure to improve motivation and boost creative thinking.

A hybrid acquisition can provide a corporation with an efficient vehicle for learning about new products and technologies. It can also serve as a platform for additional acquisitions.

When both sides understand the benefits of hybrid acquisitions, highly rewarding synergies can take place. As we see more and more hybrid acquisitions pay off, the concept will no longer seem daring but instead will become a basic part of many corporate M&A strategies. ■

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