

The Art Of The Deal

Describing his approach to investing, Warren Buffett once said, “Be fearful when others are greedy and greedy when others are fearful.” The wisdom of this observation, which can roughly be distilled as “buy low and sell high,” has been amply confirmed by decades of music industry merger and acquisition activity. The cast of characters, the products involved, and the company names keep changing, but some truths about buyouts have remained constant. The successful ones are those where buyers kept expectations in check and set limits on leverage and how much they were willing to pay. The disappointing ones usually occurred at market peaks where unrestrained enthusiasm led to elevated valuations in the belief that the good times would continue indefinitely. Two case studies are instructive.

In 1985, the country was still recovering from a deep recession, MIDI was still new and the general public was transfixed by synthesizers, disco ruled the airwaves, and the conventional wisdom was that the guitar market was destined to shrink. Against this grim backdrop, a group of investors led by the late Bill Schultz stepped up to buy Fender guitars. Corporate parent CBS was anxious to get the guitar maker off its books, and there were no other viable buyers on the horizon, enabling Schultz negotiate a below-book-value price for the company. For just \$9 million, he picked up \$14 million worth of Fender inventory and receivables, getting the trademark and designs for free. Schultz’s deal was predicated on the modest goal of ramping Fender revenues up to \$30 million. Eventually, Fender’s top line exceeded that projection by a factor of 15, making the transaction an unqualified success.

Avid’s 2004 acquisition of M-Audio provides a contrast. On the assumption that growth in the then-new home recording market was poised to accelerate, the maker of ProTools software paid \$174 million to acquire M-Audio, which had revenues of just \$51 million. Avid CEO David Krall projected five years of 40% annual growth, reasoning that Apple’s recently released Garage Band would inspire millions of consumers to take up multi-track recording. The projected market expansion failed to materialize while simultaneously a flood of competitive products eroded M-Audio’s market position. In 2013 Avid conceded its mistake with a significant write-down when it sold M-Audio for just \$17 million.

Overpaying for an acquisition doesn’t just risk disappointing investors; it very often has a corrosive effect on otherwise healthy companies. The inflated price typically leads the acquirer to expect a comparably inflated, if unrealistic, rate of return. If the financials disappoint, which they often do, rather than own up to a misguided purchase, top management is more likely to blame underlings for a lack of vision, inade-

quate effort, or just “not getting it.” In the resulting “make the numbers or else” culture, sales teams creatively stuff product into the distribution channel to make quotas, engineers rush less than optimal products to market in hopes of a “home run,” or production managers relax quality standards. Stubborn market realities ultimately intrude when retailers say “no more,” the brand name loses some luster, customer complaints rise, and company morale plummets. Layoffs, write-downs, and diminished market standing are the eventual consequences.

These reflections are prompted by the Chapter 11 filing of Gibson Brands, covered elsewhere in this issue. The Gibson story over the past three decades is bracketed by a perfectly timed acquisition and a disastrous one. When Henry Juskiewicz and Dave Berryman bought the guitar maker in 1986, they saw value that others overlooked. Gibson was losing about \$1.0 million a year on \$8.0 million in revenues, and few thought it had much chance for survival. Bucking the consensus, Juskiewicz and Berryman thought that obits for the



guitar were premature and that Gibson’s heritage and status among players represented an enormous undervalued asset. The company’s subsequent revival more than vindicated their assessment. Their 2014 venture into the consumer audio market with the acquisition of the Woox electronics division of Philips NV was, to put it kindly, much less successful.

Debt incurred in the purchase, combined with sharp declines in the sales of headphones and Bluetooth speakers, brought the entire company down, wiping out the shareholders’ investment.

As Gibson liquidates its consumer electronics operations and charts a course through bankruptcy courts, lives are being disrupted and expectations disappointed. If there is any good news to be found amidst the hardship, it’s that the Gibson guitar will emerge as a viable concern. The trademark continues to resonate worldwide, the product line includes proven instruments for every musical genre, and the guitar market remains healthy. The best hope is that private equity firms KKR and Silver Lake have arrived at a final purchase price that leaves Gibson with a manageable debt burden and allows for realistic financial expectations going forward. If so, a few years from now, this current financial mess should be just a footnote in the history of one of the industry’s most storied instrument makers.

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