Merger & Acquisition Focus

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Ask the Advisor

Celebrating Over 25 Years

Everingham & Kerr, Inc.

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Improving your risk profile

Make an M&A deal more attractive to lenders

It's no secret that lenders have grown more conservative lately. Even though the credit crisis has abated, banks remain wary about uncertain markets. And more stringent "stress tests" have put them on their guard against excessive risk. As a result, otherwise qualified borrowers with second-lien loans, significant leverage, diminishing cash and other risky traits may have trouble finding M&A financing.

If your deal is threatened by financing uncertainty, take heart. In many cases, buyers can make changes that reduce their lending risk and help them qualify for a bank loan.

A changed world

Although 2016 looks far better than 2008, plenty of unknowns remain — and the banking industry is proceeding cautiously. The Federal Reserve's annual stress tests, intended to ensure that banks have adequate capital to continue lending even after a severe market setback or long recession, has put them under enormous pressure.

If you have significant unsecured or second-lien debt on your balance sheet, lenders may consider your proposed deal too hot to handle.

Stress tests apply to roughly 30 U.S. banks with more than $50 billion in assets. In December 2015, the Fed announced even more stringent criteria for banks that have over $250 billion in assets. Such screw-tightening is likely to force many banks to sell off a certain number of loans at the end of each year to pass stress tests. This could make them less willing to lend to borrowers with their eye on an acquisition.

Diminishing appetites

In related news, banks are finding it more difficult to sell their M&A-related debt to investors. For example, Morgan Stanley struggled in late 2015 to sell the $1.2 billion loan that funded Lannett's purchase of Kremers Urban Pharmaceuticals after news broke that Kremers had lost a key customer.

During the same period, Goldman Sachs and J.P. Morgan Chase labored to sell loans backing Apax Partners' leveraged buyout of clothing retailer FullBeauty Brands. The clothier's loan package was split between first-lien loans (which are first in line for repayment should the borrower go bankrupt) and second-tier loans (which are repaid only after first-lien lenders get their money back). A substantial amount of second-tier debt apparently soured investors on the deal and the banks had to offer deep discounts to unload the loans.

Too hot to handle?

For prospective M&A dealmakers, the lesson is clear. If you have significant unsecured, second-lien or similar debt obligations on your balance sheet, lenders may consider your proposed deal too hot to handle.

To improve a deal's risk profile, sellers might try to pay down or refinance their second-class debt. Shifting to longer maturities or swapping second-lien for first-lien loans (even if this requires making price concessions) can strengthen a buyer's financing prospects — and the selling owner's chance of closing a lucrative transaction.

For their part, buyers need to factor in the health of their market sector and decide whether now — or perhaps a year or two from now — is the best time to make an acquisition. Lenders are cautious about extending loans for acquisitions in stalled industries. The energy sector, for example, currently is unpopular due to low oil prices. These days, service sector applicants are more likely to find receptive lenders.

Lenders also look less favorably on slower-track deals. In the past, banks would "warehouse" M&A loans until they found a favorable market for them. Now, because of greater regulatory pressure, they're often forced to sell such loans quickly to get them off their books — even when the market isn't in the mood to pay top dollar. Therefore, loan applicants that can guarantee that a transaction will close quickly and by a certain date have an advantage.

Making it work

Under current conditions, it's clear why lenders have cold feet when it comes to funding acquisitions. Whether you're an M&A buyer or seller, you'll have better odds of closing a deal if you trim your risk profile. ■

Taking banks out of the picture

One way to avoid deal financing problems is to walk right past the banks. Easier said than done, right? But there may be alternatives to traditional lenders that you haven't considered.

First is the all-cash deal, in which a buyer funds its purchase with its own cash holdings. Many companies have amassed substantial reserves over the past five years but are prevented from using them by shareholders. If your shareholders are worried about depleting capital reserves to make a purchase, you may need to devote more time and energy to selling them on the deal.

Seller financing is another possible option. Your seller might be willing to accept a lower initial purchase price in return for earnout provisions (installment payments, sometimes tied to performance) or an opportunity to participate in the future success of the merged company.

Finally, think about accepting private equity partners. PE funds usually have fewer regulatory constraints and a greater appetite for risk. But these investors also expect high returns (typically from companies in fast-growing industries) and are likely to want a say in how any M&A deal is structured.

Beyond financials: A look at key value drivers

Make no mistake: Your company's financial statements will be the primary reason buyers are attracted — or not attracted — to your business. However, other factors, commonly referred to as key value drivers, can boost your company's M&A market prospects and possibly spark interest from buyers that would otherwise pass you by.

Key value drivers can range from a business's cultural compatibility with a potential buyer to significant real estate holdings to desirable intellectual property. What's important is that a seller's drivers complement an already compelling financial story.

Customers and competitors

One of the best ways to demonstrate your company's value is with customers. Most buyers like to see a diversified customer base. That's because a company that depends on a limited number of key customers is vulnerable to financial disaster if it loses only one or two accounts. A customer base that extends across several geographic regions or market sectors also may appeal to some buyers concerned about concentration risk.

Your company's industry can also be a value driver for some buyers — particularly if the sector is expanding rapidly. Large, established companies often prefer to buy a startup in a young, hot industry rather than attempt organic growth in an unfamiliar environment. Keep in mind, though, that you can't use industry as your sole selling point. To get top dollar, your company must distinguish itself from its fast-growing competitors with, for example, unique intellectual property or unusually efficient supply chains.

Internal assets

Internal factors also drive buyers in your company's direction. Depending on your suitor and its larger strategic goals, you might want to emphasize the following attributes:

Management talent. Is your company's management bench deep and capable of running the business successfully without its current owner? Have managers signed contracts or been offered incentives to remain after the sale? Many buyers consider key employees' willingness to stay on critical to their offering price — and even to the deal's viability.

Employee tenure and morale. Do you have many long-term employees or is your business plagued with high turnover? Have you clashed with employee unions or been hit with discrimination suits? Buyers generally prefer companies with happy and committed workforces that will be reasonably easy to integrate into their own organization.

Physical appearance. Are your office, service and production facilities clean and well maintained? Are your website and social media pages up to date and easy to navigate? Is your software and hardware current and effective? A dated company logo, poorly maintained database or even worn reception-area furniture tells prospective buyers that your company has seen better days. On the other hand, good organization and a strong "curb appeal" can be key selling points with buyers looking for a turnkey opportunity.

Products that pay

Some buyers focus primarily on the products and services they'll be acquiring. Goods backed by proprietary information (such as a special manufacturing process) will appeal to most buyers because they potentially offer higher profit margins and a unique marketing story.

Growth potential and market exclusivity are also attractive. Do your products have strong brand recognition? With an additional infusion of capital, a seller might be able to build on your brand and market position by adding products and expanding territories.

Is your management bench deep and capable of running the business successfully without you?

Making a future case

These are only a few of the many value drivers that can help you sell your business. Before putting your company on the market, look closely at all of your assets and strengths and decide which ones are most likely to appeal to potential buyers.

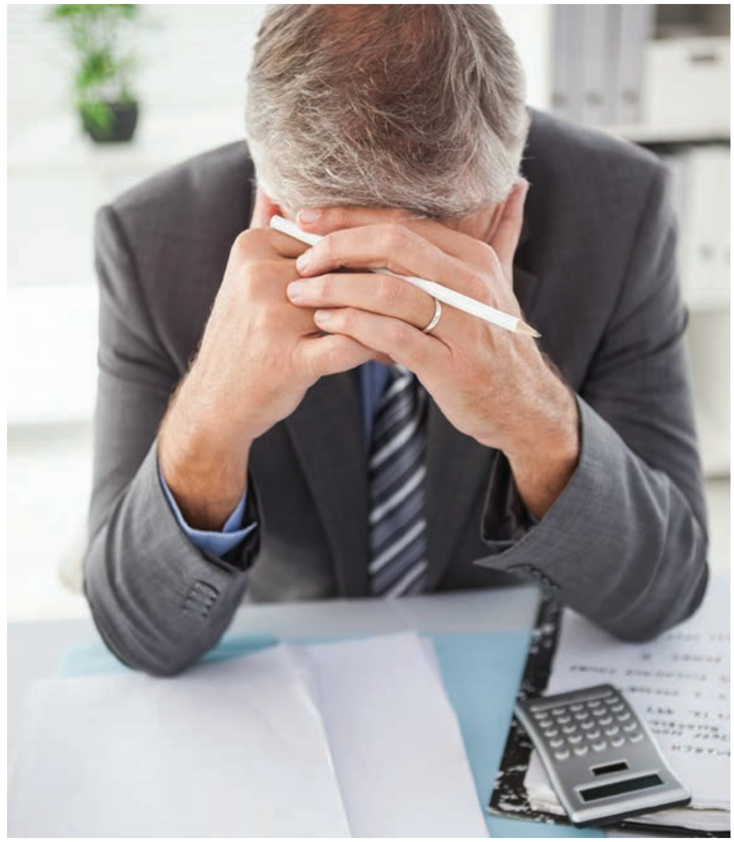
Don't overlook the opportunities you've been unable or unwilling to tap. A new owner with greater resources may regard even business challenges as valuable growth propositions. ■

How to avoid 5 common seller mistakes

It's easy to make mistakes when you're a first-time seller. No matter how successful your business or how well you know it and your industry, you're probably not prepared for the complexities of preparing to sell, finding a buyer and negotiating a deal. To help ensure that your transaction is profitable — and actually crosses the finish line — be sure to avoid these common mistakes:

1. Poor financial reporting. Sloppy accounting and inaccurate financial statements probably turn off more buyers than any other seller mistake. That's why you need an outside accountant to prepare audited financials at least two years before you try to sell your business. Private companies aren't required to adopt Generally Accepted Accounting Principles (GAAP). But you may want to consider it anyway — particularly if your prospective suitors are public companies, which *are* required to follow GAAP.

2. Emphasizing your role. It's natural for owners to be proud of the business they've built and to let sellers know how much it depends on them to run smoothly and profitably. But keep in mind that what buyers want is a business that will run smoothly *after* the current owner has moved on. So instead of tooting your own horn, talk about the strength of your management team and explain how a buyer might easily integrate operations and employees into its own organization. If a potential buyer is still concerned about losing your leadership and expertise, you might offer to remain for a specified period after the sale to help with integration and to train successors.



3. Owning real estate outside the company. Many owners remove assets from their company as a way to create financial security. Unfortunately, this can leave buyers with too few assets to borrow against. Banks have tightened their purses — and lending requirements — making financing an acquisition challenging for buyers. Make sure you're helping, not hindering, buyers.

4. Setting a high asking price. Although many sellers set an asking price as part of an offering, consider leaving off the price tag — at least initially. Instead, let buyers get interested first, and then they can start bidding. If bids aren't as high as you think they should be, consider whether your expectations are realistic. Because of the emotions attached, founding owners in particular tend to overestimate the value of their business. But buyers base their bids on objective information — for example, your company's assets and financial statements, and potential cost synergies.

Sloppy accounting and inaccurate financial statements probably turn off more buyers than any other seller mistake.

5. Excessive personal business within the company. Because it lowers taxable profits, many business owners include some personal expenses inside their company. Buyers understand and accept this and similar tax-minimizing practices — up to a point. Just make sure that such expenses are easy to explain and that your accounting methods don't come across as convoluted or deceptive. You can help prospective buyers understand what the company would look like under new ownership by providing an "adjusted" statement that presents your financials without unnecessary or extraordinary expenses.

It's also common for smaller businesses to employ family members. This can make selling your company more difficult if buyers are confused or skeptical about family members' individual contributions. Buyers may also worry about whether these employees will stay on after the sale and, if so, whether they'll remain motivated to work hard under new ownership.

You can help avoid all of the above pitfalls by working with experienced professionals. At a minimum, consult an M&A specialist, a CPA and an attorney. And if you're entering retirement, be sure to discuss your plans with financial and estate planners. ■

Ask the Advisor

Q. How might taxes affect my spinoff?

A: Structuring a spinoff can be challenging, especially when you consider the tax implications of such a transaction. In fact, when a spinoff is viewed from the IRS perspective, some companies decide to return to the drawing board.

Qualifying factors

Under Internal Revenue Code (IRC) Section 355, spinoffs usually are tax-free. This means that neither the parent company nor its shareholders recognize any taxable gain.

But for a spinoff to qualify for tax-free status, it must meet several requirements:

- ❖ The parent company and its subsidiary must be engaged in active business for at least five years before and five years after the spinoff.
- ❖ The parent needs to own at least 80% of the subsidiary's voting stock before the spinoff and then relinquish at least 80% of this stock post-spinoff.
- ❖ There must be a "valid" business purpose for the spinoff — companies can't use them simply to shift a subsidiary's earnings and profits to shareholders to avoid taxes.
- ❖ At least one shareholder of the parent company needs to retain a "continuity of interest" in both companies for two years prior to the spinoff and two years after it.

If such conditions aren't met and you forge ahead anyway, your spinoff could result in a crushing tax bill.

Case study

Recently, Yahoo abandoned spinoff plans for one of its units. The company intended to minimize tax exposure by selling its 15% stake in China's Alibaba to shareholders via a newly formed company. If the company had just sold the shares outright, it would have had to pay up to $10 billion in taxes.

But Yahoo failed to convince the IRS that its "forward" spinoff qualified as a tax-free transaction. The IRS objected to Yahoo's plans to move its small-business services unit into the spinoff company (Aabaco), because the unit wouldn't be large enough relative to the Alibaba stake to justify Aabaco's business purpose. Now the company is working on a "reverse" spinoff, which will involve shifting core business assets to a newly formed subsidiary, and leaving Alibaba separate.

Play by the rules

Yahoo's case is unusual, given the value of its Alibaba stake. But if your business is considering a similar move, it pays to study how even giant companies fare when they attempt creative spinoff structures. If you'd like to streamline your operations and move noncore assets to a separate entity without incurring taxes, be sure your spinoff plays by the rules. ■

Celebrating Over 25 Years

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Passing the Business Torch ... One Successful Transaction at a Time

Our Firm:

Everingham & Kerr (E&K) is a regional merger and acquisition advisory firm focused on implementing exit and growth strategies for lower middle market companies. Our client base includes private and publicly owned companies, investor groups, family businesses and entrepreneurs. Since 1988, the firm has successfully completed over 350 transactions spanning virtually every industry sector.

Our Maxim:

Combining Experience, Teamwork and Persistence to Produce Superior Results.

Our Services:

Sales:

E&K provides representation to sellers of lower middle market companies including sales of entrepreneur and family owned companies as well as divestitures of business units of private and publicly owned companies.

Acquisitions:

E&K assists companies, entrepreneurs and corporate executives develop and execute customized acquisition strategies designed to result in successful transactions.

Transaction Consulting:

In some instances the parties to a transaction locate each other through informal industry or personal channels. These transactions include sales to unrelated third party acquirers, as well as management, family and partner buyouts. E&K is often engaged to structure these transactions and navigate the many issues requiring attention from the initial stages to the consummation of the transaction.

Business Valuations:

E&K provides a full range of valuation services to business owners for personal and corporate affairs. Supporting our belief that all owners should know the “real” value of their business, E&K offers the “Owner’s Planning Valuation”. This is an informal valuation that can be prepared in a cost-effective manner and updated periodically to assist owners with company and personal planning issues.

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