

Merger & Acquisition Focus



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Why buyers should give sellers a stake in the deal

Writing your M&A playbook: A strategic exercise for sellers

Take the money — and stay
Partial sales provide owners with options

Ask the Advisor



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Why buyers should give sellers a stake in the deal

Business buyers can be so intent on achieving their own strategic objectives that they downplay or ignore possible roles sellers may play postmerger. That could be a mistake — or, at the very least, a missed opportunity.

Cooperative sellers, for example, can reduce a buyer's integration workload by ensuring that functions, such as accounting, sales and IT, are ready to make the transition. Possibly more significant, a seller with a stake in the deal's success will likely encourage key employees to remain with the business after the deal closes. The bottom line: When sellers are given financial incentives to help close and integrate a deal, its long-term prospects generally improve.

Earnout goals

Most buyers incentivize sellers with a financial arrangement known as an “earnout.” Earnouts often are used to bridge price disputes between two parties or to finance part of the purchase price. The buyer agrees to pay part up front and the remaining amount after the companies have merged and certain conditions have been met.

To prevent sellers from getting the short end of the stick, earnout agreements should be clear and carefully drafted.

When an earnout is used to encourage seller cooperation, the previous owner remains with the company in some capacity after the deal closes, often receiving weekly or monthly paychecks or consulting fees for their day-to-day involvement in



the business. Transition periods of three to five years are common and owners are required to sign an employment agreement for that period.

At the end of the contractual period, the seller receives compensation in the form of stock options in the new company, the final installment on the business's original sale price, additional consulting fees or a combination of these. To receive full payment, the selling owner must meet a previously determined set of objectives, such as:

Financial performance. The parties might project specific earnings or revenue growth targets over a three- to five-year period.

Cost synergies. The buyer and seller determine that the merged organization should achieve overall or unit-by-unit cost savings.

Strategic goals. Major objectives, such as improving market share by a certain percentage or successfully rolling out a new product, must be met.

Avoiding risks and complications

Earnouts offer obvious benefits for buyers, who don't have to pay sellers unless the deal is successful. To prevent sellers from getting the short end of the stick, earnout agreements should be clear and carefully drafted to ensure that goals are reasonable and achievable.

Buyers who try to lard earnout agreements with an interlinked set of tasks — such as mandating specific customer retention levels along with hitting earnings benchmarks — risk alienating sellers and are likely to encounter pushback during deal negotiations. Buyers also should provide selling owners with some degree of flexibility. Contradicting or micromanaging the seller is likely to lead to conflict or possibly a lawsuit alleging that the buyer interfered with the seller's efforts to achieve the earnout's objectives.

Setting limits

At the same time, buyers risk giving sellers too much power and autonomy. If the selling company is financially troubled or has been healthy historically but has underperformed recently, it

probably doesn't make sense to pay an owner to continue running it.

Also, buyers with a strong, unified corporate culture may have trouble accommodating semi-independent entrepreneurs working in their midst. Sellers who stay on can slow down long-term integration because they're unwilling to adapt to the new regime or because they retain the loyalty of former employees.

Weighing options

If you're buying a company, you want the previous owner "in your corner" to some extent. A smooth integration and transition period may require an earnout structure to ensure both parties have a stake in the deal's long-term success.

But buyers also need to consider potential pitfalls. Will keeping the previous owner on staff actually benefit the merged company's performance? Or is it simply a strategy to reduce the up-front purchase price? If the latter is true, ask your M&A advisor about other financial risk-mitigation strategies that don't involve giving your acquisition's former owner a stake in its future. ■

Writing your M&A playbook: A strategic exercise for sellers

If you're thinking about selling your company, consider assembling an M&A "playbook." The process can help put you in a merger mindset and enable you to make an early assessment of your company's key selling points and possible weaknesses, as well as identify opportunities to enhance value.

A frank assessment

A playbook isn't a white paper or formal presentation, but a critical self-assessment meant for your



The buyer scorecard

Playbooks are about more than navel-gazing. Business sellers should also use them to review and rank prospective suitors. You never know where you'll find a buyer — from among the ranks of your closest competitors to a large, diversified company that's trying to gain a foothold in your industry.

Evaluate potential buyers on several fronts, including their:

- ❖ Deal history, such as the number of acquisitions they've made and how successful they turned out,
- ❖ Capitalization and whether they're capable of making a cash acquisition or have secured financing from another source, and
- ❖ Similarity of culture and whether the buyer will expect your company to adopt its own.

The process of compiling a list of potential suitors is worthwhile, even if your eventual buyer isn't included. As you drill down into the pool of potential buyers, you and your managers will begin to draw a portrait of the ideal buyer. Many first-time sellers prioritize price, but the more buyers they consider, the more likely they are to put a premium on such qualities as assured financing, congruent corporate culture and integration experience.



and your managers' eyes only. Ideally, it should help your deal team get the business in fighting shape before it enters the M&A marketplace.

Your playbook can cover several subjects, but three critical ones for most companies are:

1. Strengths. What makes your business unique? Which are your bestselling products, most lucrative client contracts or most valuable intellectual property? Pinpoint your most promising research and development projects and management strengths. You'll want to emphasize such features when you decide it's time to sell.

2. Weaknesses. Where is your company vulnerable? Are there market sectors in which you've failed to gain a foothold or where you're losing out to competitors? Do you rely on a few key people or customers for your business's success? Pay particular attention to underperforming products or divisions and red flags in your financial statements, such as excessive debt or volatile earnings. When you sell, you'll want to play up how you remedied weaknesses — or describe continuing efforts if a fix is still in the works.

3. Market position. How does your company rank among competitors in terms of market share and earnings? What would it take to improve your market position? For example, a modest infusion of new capital or synergistic sales teams might be all you need to catapult to the No. 1 spot.

Buyer's eye view

To ensure you're being as objective as possible, draft your playbook from a potential buyer's perspective. (See "The buyer scorecard" at left.) If you feel uncomfortable playing the buyer's role, consider enlisting the help of experienced M&A advisors who are familiar with your sector and what actual buyers are currently seeking in an acquisition.

If your company needs major operational improvements or is in worse fiscal condition than its competitors, it's far better to discover this at the playbook stage than when you're courting buyers or facing due

diligence scrutiny. Some problems may take several years to resolve. Others may not be fixable. In that case, decide how you'll cast weaknesses in the most positive light without being dishonest.

Strategic tool

If the assessment exercise reveals that your company is in good shape to sell, the next step is to devise a selling strategy. Start by making personnel assignments for such important tasks as screening potential buyers and preparing due diligence materials. Some companies choose to involve only a few upper managers, while others assemble a larger, more inclusive deal team.

Also determine deal terms and pricing issues so you're prepared to have quality discussions with prospective buyers. You likely have a list of "must haves," such as a range of acceptable prices, a tax-efficient structure or certain seller protections.

Document them in your playbook so you don't later lose sight of what's important.

Also use your playbook to sketch a rough timeline. Will you be ready to put out the "for sale" sign in the next two months or two years? Consider everything from your current debt load to future earnings projections to the strength of the general economy.

Practice is essential

Of course, there's only so much planning you can do. Real-life M&A deals often lead in unexpected directions. But a playbook gives you a chance to carefully assess your business and map out a selling strategy. Even if you don't intend to sell anytime soon, this exercise can help you focus on strengths and fix any weaknesses so that your company will one day be a desirable acquisition target. ■

Take the money — and stay

PARTIAL SALES PROVIDE OWNERS WITH OPTIONS

Selling your business doesn't have to be an either-or proposition. Many buyers are interested in taking only a minority stake in a company — which means you can raise new capital *and* retain some control of your business. A partial sale may also be a good way to gain valuable strategic advice, receive a capital infusion and possibly reap other advantages.

2 popular approaches

Partial sales can take many forms, but these are the two most common:

1. Minority investors. Usually the easiest route is to find one or more institutional or individual investors interested in acquiring a minority stake in your company. You receive a quick cash infusion

to reinvest in your business (or use for other purposes) and retain majority ownership.

In most cases, you continue to have the final word on your company's strategic decisions. However, minority investors may ask for certain rights and restrictions, such as the option to acquire a majority stake upon certain conditions or triggers. Or they may request the right to approve major decisions — such as purchases, divestitures, refinancing, major stock transfers, and key management and board changes — until their investment is recouped.

2. Recapitalization. In this type of transaction, your company replaces its current sources of financing with new ones — for example, issuing new equity

or debt to buy off the old. With one recapitalization method, the owner sells his or her equity in the company to a financial “sponsor,” such as a private-equity fund. Sponsors also generally require the company’s owner and part or all of the original management team to remain in place to run day-to-day operations for a specified time period.

Positive points

If you’re not sure whether you should make a partial sale, consider some benefits. For example, new capital from a partial sale can help your company expand and increase market share. In turn, this boosts value and can lead to a larger payoff when you eventually sell your remaining stake.

Also, by accepting new investors, you’re likely to gain business partners with M&A deal experience. These partial owners can be a good resource if you’re interested in expanding via acquisitions. And if you want to sell your full stake in the company at some point, your partners can help you prepare the business for sale and advise you on potential buyers. In fact, some partial owners end up buying out the original owners if the company’s performance exceeds its investors’ expectations.

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What’s more, a partial sale can help your company identify the best candidates for future succession and enable your exit strategy. Sponsors, for example, typically encourage top performers and promising managers to invest in the company.

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Watch for pitfalls

Naturally, selling a portion of your company isn’t without risks. For example, a poor relationship with a financial sponsor could wreak havoc on your



business. If the sponsor is unhappy with the relationship and has a majority stake, it could even try to sell your company without your input or approval.

That’s why it’s important to carefully screen potential partners. Private-equity and other financial investors typically plan to own a company for five to seven years before selling it. So assume you’ll be working with your partial owner for at least that long. Because these types of investors usually specialize, team up with people who’ve worked successfully with other companies in your sector.

A shared vision

If you’ve been unable to decide whether you want to sell your business, a partial sale may be the solution. Just be sure you pick your partner carefully. The ideal part-owner not only shares a similar vision with you about the future of the business, but also brings new ideas and expertise to the table. ■

Ask the Advisor

Q. Should I sell my company now that the market has picked up?



A. After nearly a decade of disappointing M&A market activity, 2014 looks to be that rare thing: a boom year. If sales momentum continues into 2015, many prospective sellers could benefit.

Signs of recovery

According to Thomson Reuters, the first quarter of 2014 was the strongest start for new M&A deals since 2011, with worldwide mergers totaling \$742 billion, up 35% over the first quarter of 2013. Although Comcast's \$45 billion bid for Time Warner Cable has pumped up these numbers, there's also been significant M&A activity in the energy, telecom and pharmaceuticals sectors.

Will this surge taper off or will the boom keep gathering momentum? The signs seem favorable. Several factors are expected to fuel new merger activity into next year, including:

- ❖ A steadily recovering U.S. economy,
- ❖ Low interest rates,
- ❖ Pent-up buyer demand,
- ❖ Cash-rich buyers, and
- ❖ Encouraging trends in Europe and other previously struggling economies.



That said, even the most ideal macroeconomic conditions don't guarantee that buyers willing to pay top dollar will flock to your company. You need to be in good shape to sell to maximize your selling price.

Greater competition

Higher deal volume should work to the advantage of healthy sellers by providing a larger pool of qualified buyers competing for target acquisitions. The best-case scenario is that you'll attract several competitive buyers that engage in a bidding war for your company.

On the downside, buyers could be looking aggressively for bargains, assuming that hungry sellers will accept any price. If your company is an attractive target, boasting such qualities as a strong balance sheet, low debt, proprietary products and a desirable customer base, you can probably afford to stand your ground on price and other deal conditions. Depending on your company's profitability and growth prospects, a booming M&A market means that, if you turn one buyer down, you can be reasonably confident that another will come along.

Let the good times roll

Both buyers and sellers that have been waiting on the sidelines for years are breathing a sigh of relief that the M&A market once again is healthy. Sellers, in particular, can afford to be selective and weigh offers instead of rushing into dubious deals. As for the ideal time to sell, don't base your decision on external factors, such as deal volume or interest rates. The most important factor is whether you and your business are ready to take this big step. ■



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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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