

Merger & Acquisition Focus



October/November 2013

Head off acquisition anxiety —
and get your deal done

Selling your company

Hold on to key employees
with bonuses and perks

Sector matters

How industry helps
determine M&A success

Ask the Advisor



Everingham & Kerr, Inc.

Merger & Acquisition Advisors focused on the Lower Middle Market

1300 Route 73, Suite 103, Mt. Laurel, NJ 08054

Phone: 856.546.6655, Fax: 856.546.2806

Email: EK@everkerr.com, Website: www.everkerr.com

Head off acquisition anxiety — and get your deal done

It's not uncommon. Only weeks or days before an M&A deal is scheduled to close, the seller gets cold feet. And it's certainly understandable. Selling the company you've built for many years is a big psychological hurdle for an owner to clear.

However, it's important that you not let such qualms upset negotiations or the deal's final steps. By acknowledging and preparing for potential triggers, you'll be able to handle last-minute jitters that could otherwise derail your transaction.

Keeping a cool head

Misgivings can begin early in the deal process, particularly if you've built your business from scratch or inherited it from a family member. The prospect of a "stranger" digging into its history during due diligence is likely to feel at least a little invasive. Every business decision you've ever made — each hire, product design, office opening, acquisition — could be reviewed and second-guessed.

But it's important to control the urge to become defensive or argumentative. After all, buyers have

the right to verify that they're getting what they're paying for. To help ensure you'll keep a cool head, consider doing the following:

Stage a dress rehearsal. Before due diligence starts, your own deal team should vet your company. View every financial and legal document you'll be providing the buyer and anticipate difficult questions by practicing appropriate responses. Your answers should put any negative or costly business decisions you've made in the past into context.

Work with experts. Third-party advisors with M&A expertise can provide a buffer between you and your buyer. When you begin to feel personally affronted by sharp buyer questions, for example, your advisors can take over. Advisors can also coach you about how to present unfavorable information and reassure you that everything is on track, even if you fear it isn't.

Keep it positive. Don't volunteer negative information, particularly during the deal's early stages. Instead, gauge your buyer's primary interest — whether it's a product line, certain intellectual property or your executive team — and focus on that. If your buyer shows no interest in delving into contentious employee-management relations, don't bring them up.

The trouble with high expectations

Owners who have been preparing for a sale for many years sometimes harbor overly high expectations. For example, you may envision the ideal



buyer or sale price — which can set you up for disappointment when things don't go exactly according to plan.

High expectations can even hurt your chances of selling well. You might get so caught up in timing your deal — waiting to put your company on the market when its growth cycle and general economic conditions are “perfect”— that you miss good selling opportunities.

Try to recognize that no deal will go according to plan. In fact, almost all M&A transactions require *both* parties to compromise on critical points.

Left at the altar?

Another potential stumbling block is fear that your M&A deal will fall apart before it closes. You can reduce “being left at the altar” concerns by purchasing deal insurance.

Depending on the policy, insurance can cover some or all deal-associated costs should the transaction collapse. Your buyer also may provide certain concessions such as covering legal and accounting expenses if specific timelines and benchmarks aren't met.

But while insurance can provide some peace of mind, confidence in your buyer's intentions is even more important. Regularly communicating with your buyer and working through potentially contentious issues can help build trust. For example, if you don't know what your buyer's intentions are for a particular product or office, don't mull over worst-case scenarios. Press the buyer for answers, which are likely to leave you reassured.

If they don't, and you're still unsure about your buyer's motivations as you approach the price negotiation stage, you might want to take a step back. Your concerns about the deal may, in fact, be completely reasonable. (See “When premerger jitters are justified” below.)

Keep your poise

A business sale can be a psychologically fraught process, often representing the culmination of a long professional life. The key to managing stress and staying on course is to anticipate jitters and doubts and rehearse how you'll manage them.

Also know that, with the help of experienced professional advisors, most sellers are satisfied when their deals finally close. ■

When premerger jitters are justified

Sometimes, a business seller's premerger anxieties signal more than cold feet. It's important to be able to recognize the difference between nerves and legitimate concerns about a potential deal.

Most warning signs turn up during the deal negotiation stage. A buyer, for example, might push for an all- or mainly stock purchase, which would tie the amount of sale proceeds to the merged company's future performance and stock liquidity. Yet the buyer might not be prepared for a fast and efficient integration process, which is critical to any merger's success. In this scenario, a seller might be justified in having second thoughts.

An “easy” due diligence process can also be a red flag. Take a buyer that fails to dig too deep or seems unconcerned about how issues uncovered in due diligence might affect the acquisition's long-term chances. Such attitudes could indicate that the buyer will be a neglectful owner, or that it intends to resell your company quickly or write it down as a loss — regardless of how it affects employees or your legacy.

SELLING YOUR COMPANY

Hold on to key employees with bonuses and perks

Ryan's software company was being courted by a large corporation with financial resources that would enable him to expand his offerings and reach new markets. The transaction was progressing according to plan — until the two companies announced their impending merger. That's when Ryan's Chief Technology Officer and several of his key developers resigned. A few weeks later, the deal fell apart.

This scenario is more common than you might think. If a handful of key players are critical to your company's value, you need to provide them with incentives to stay while you close an M&A deal, as well as through the integration process.

Emotional stakes

As soon as initial negotiations with a buyer begin, identify your most valuable employees — for example, executives who will be responsible for integrating the company, top salespeople, product developers, and managers responsible for a significant percentage of revenues. Such employees typically represent less than 10% of a business's workforce.

Almost nothing can damage the morale of a valuable employee faster than learning about a merger through the grapevine. Therefore, keep your key staff members in the loop, informing them of your plans as soon as possible and even involving them in the M&A process. You might, for example, add them to your deal team and assign them to preintegration tasks that enable them to work with employees from the buyer's company. All of this gives key people an emotional stake in the deal.

Financial incentives

Along with the need to feel like they have a role in your company's future, key employees are likely to respond to various financial incentives. Stock options in the newly merged company are one of the most common. Typically, they're offered to executives and top managers and can be an excellent way to motivate their performance during integration and beyond.

“Management-by-objectives” bonuses reward employees for completing tasks that might otherwise be neglected during a merger.

Or, you might offer a stay bonus, which rewards employees who agree to stay for a specified period, such as two years. It can be paid in a lump sum (usually a percentage of their current salary). As an alternative to stay bonuses, some companies offer key employees a deferred bonus, with interest, due to be paid at some specified time in the future or when they reach certain department or company milestones. Employees may even respond positively to the offer of extra vacation time, an improved health care package or supplemental insurance policies such as disability or long-term care.

Some of these incentives have the potential to become costly over the long term, so consider offering task-specific rewards. You might, for example, promise a completion bonus for projects essential to your M&A deal, such as

successfully conducting layoffs of redundant staff or integrating your IT network with your buyer's. You also could offer "management-by-objectives" bonuses, which reward employees for completing tasks that might otherwise be neglected during the course of a merger.

Attractive supplements

There's a limit, of course, to the financial incentives you can offer employees to stay on board. To supplement financial incentive plans or engage employees who aren't necessarily motivated to stay by the offer of more money, work with your buyer to come up with some *nonfinancial* perks that you can selectively offer to holdout employees.

Often, these are relatively easy to provide, such as the guarantee of a new job title or responsibility for particular client accounts. Some employees may be more likely to remain loyal if they can take essential employees such as a trusted executive

assistant or IT technician with them to the new company. Others may be motivated by the offer of more-flexible work hours or the ability to telecommute from home.

Cost is relative

Business owner Ryan learned the hard way that you can't afford to take key employees for granted. Providing incentives can be costly, but they tend to cost less than the loss of essential staff when you're trying to close an M&A deal. ■



Sector matters

HOW INDUSTRY HELPS DETERMINE M&A SUCCESS

Sometimes business buyers focus too much on the specific characteristics of a company and not enough on its industry. While a target's financials should be your first consideration,

it's important that you also fully understand its sector's competitive landscape, financial strength and growth potential. Otherwise, you risk buying a strong company in a troubled sector, among other mistakes that might doom your deal.

Research checklist

Before you enter serious deal talks with a seller, there are several things you need to know about its sector. If you share the same industry with your target, your research is likely to be minimal — although you might consider how differences in size or location come into play. Also, if your target enjoys a special competency or differentiated product, identify new growth opportunities specific to those assets.



When you're using an acquisition to enter an entirely new market, it's necessary to perform more extensive research. Learn about the:

Cast of characters. Who are the sector's market leaders and how much share do they have? How does your acquisition target rank compared to the leaders, in terms of market share and profitability? What distinguishes the target in its market? Have any competitors eroded your target's market share in recent years?

Growth prospects. What are the industry's short- and long-term growth prospects? What are historical sales levels and how are sales currently trending? How is technological innovation affecting the foreseeable relevance of the target's products and services?

Market exposure. How connected is the sector to trends in the broader economy? Some industries may profit during recessions as well as booms, but many are cyclical and rise and fall with such general economic indicators as stock market performance and interest rate levels.

How does the acquisition target rank compared to the sector leaders, in terms of market share and profitability?

Rules and regulations. How much is the sector regulated by federal and state oversight? Does it experience an above-average number of audits and antitrust suits, and is it required to get frequent regulatory approval (as in the pharmaceuticals industry)? If so, how have regulations affected the target company's growth and expenses in the past, and what's expected in the future?



to evaluate the company. Start with its growth momentum. For example, if the company's growth has come primarily from taking market share from weaker competitors, how will it grow when the remaining competition is much fiercer?

If the seller's performance is often the result of technological or logistical innovations, look closely at how this compares with competitors' performance — or even that of other industries in which it might venture. While its development of intellectual property and adoption of new technology may compare favorably to that found in older industries, such innovation may look stodgy within IT services or biotech.

Also consider relative costs and expenses, such as employee salaries and benefits. And don't forget about leverage. If the target has heavy outstanding debt that needs to be negotiated, find out how other companies in the industry have obtained low-cost financing.

Big picture, little picture

The more you know about a prospective acquisition's industry, the better prepared you'll be to offer a competitive price and successfully integrate the company with your own. That said, sector information is a secondary consideration in most M&A deals. Even if your target is in a highly competitive or recession-battered sector, strong financials and strategic advantages such as cost synergies generally count for more in the decision-making process. ■

Due diligence stage

During the due diligence stage of your acquisition, use what you know about the target's sector

Ask the Advisor

Q: Can I reduce my company's leverage with an acquisition?



A: If your company is highly leveraged and considering ways to reduce its debt burden, an acquisition may be an option. A company using this strategy to reduce debt acquires another business and “over-equitizes” it with fresh capital. The goal is a less-leveraged combined entity — and long-term growth potential. Many factors must be in place for this strategy to work, however.

Ideal scenario

Depending on the size of the deal relative to your capital structure, you may finance the transaction yourself and immediately improve your financial ratios. For larger deals, you might partner with private equity (PE) investors to make up the balance of your acquisition capital. This will be the deal’s “sweetener,” enabling your company to make an all-cash acquisition and thus limit further leverage. Alternatively, you may use the capital to pay down debt before making the acquisition.

You also need to find the right target company. Your target should have very little leverage, high cash reserves and cash flow, reasonable



access to the public markets for financing, and, if it’s publicly traded, a good reputation in the investment community.

Strategy in action

To better understand how such a debt-reduction strategy works, let’s look at a real-life example. Infor, a software company owned by PE firm Golden Gate Capital, was struggling after the recent recession with pro forma leverage of 10 times earnings before interest, taxes, depreciation, and amortization (EBITDA). Rather than attempt to refinance its debt, Infor used some newly raised private equity capital to pay down a portion. Then it acquired rival software firm Lawson for \$2 billion.

Lawson was publicly traded, had solid cash flow and low leverage. Its solid fiscal condition helped Infor line up a first-lien bank loan (in which the lender has first priority of repayment in the event of a default) and issue low-interest public bonds to help finance the acquisition deal. In the end, the new Lawson-Infor reduces leverage to 6.5 times EBITDA.

House in order

An acquisition may enable your highly leveraged company to “marry up,” using the stronger financial condition of your target to get your own fiscal house in order. But because this strategy is dependent on many factors going your way, it’s essential to work with experienced M&A advisors.

Also keep in mind that there may be simpler solutions to your debt problems. For example, if you haven’t already, you might try to renegotiate terms with your current lenders. ■



Everingham & Kerr, Inc.

Merger & Acquisition Advisors focused on the Lower Middle Market

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 nearly 200 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.

Everingham & Kerr, Inc.

1300 Route 73, Suite 103, Mt. Laurel, NJ 08054
Phone: 856.546.6655, Fax: 856.546.2806
Email: ek@everkerr.com, Website: www.everkerr.com

We encourage you to call us at (856) 546-6655 to discuss any of our services in greater detail or visit our website at www.everkerr.com to learn more about the company.