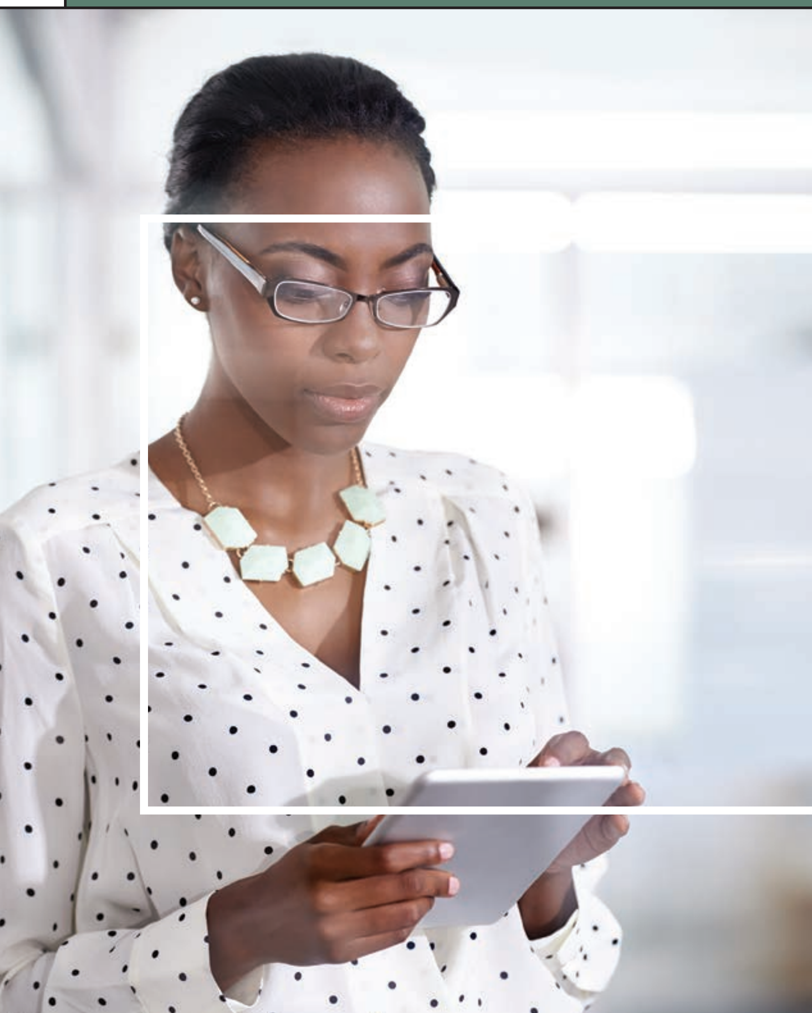
Merger & Acquisition Focus



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Preparing for a sale – even if you have no plans to sell

Turn that frown upside down
Making a distressed acquisition profitable

Even small deals may face antitrust actions

Ask the Advisor

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Preparing for a sale – even if you have no plans to sell

Many business owners are so consumed with the day-to-day responsibilities of running a company that they don't have time to consider the *idea* of selling. But even if retirement is the last thing on your mind, know this: It's never too early to start planning to sell. You never know when circumstances (such as poor health) or opportunities (an offer that's "too good to pass up") might force your hand.

"Preparing to sell" can be as simple as performing a self-assessment that identifies your company's strengths and weaknesses. The information you gather can help you focus on the most promising aspects of your business and address any issues that may be hindering profitability.

3 items

You can perform your own assessment or ask your financial advisor to perform it for you. Either way, you should end up with three items at its conclusion:

1. A clean bill of health. Look at earnings, profitability, market share and productivity over time to confirm these numbers are on an upward trajectory. Although short-term slips are to be expected, particularly when the broader economy or your market sector is weak, your company's financials should generally show positive trends. If instead of good health you spot signs of deterioration — anything from falling profit margins to declining client numbers — plan to address these issues as soon as possible.

2. A solid list of strengths. Tally your assets — physical, financial, intellectual and cultural. Determine, for example, the strongest items on your company's balance sheet, your company's most valuable assets and what your management team does particularly well. You should be able to assemble a robust list of "selling points," even if your prospective buyer is only imaginary at this point.

A minor problem that will take a lot of work to get resolved should be put on the back burner.

3. An honest accounting of weaknesses. Ask if any of your company's weaknesses are serious enough to make a buyer have second thoughts about acquiring it. If so, those same issues are probably holding your business back right now. Every company has challenges — some challenges that may seem formidable. You may have trouble raising new capital to expand, or be unable to contain rising raw materials costs. Perhaps a new competitor has entered your market.

Repair and renovate

Once you've completed your assessment, bolster and expand on strengths and fix or minimize weaknesses. Sounds like a lot of work, right? The key is prioritization.

Break each goal down into the time and money you'll need to achieve it. Some prioritization decisions are easy. For example, a minor problem that will take a lot of work to get resolved should be put on the back burner. Anything that's actually bleeding money — such as a severely underperforming segment or product — should obviously go to the top of your list, particularly if you can quickly sell or discontinue it. For all the items that fall somewhere between these two extremes, weigh how they affect your company's bottom line against how easy they are to address.

Consequences of poor preparation

Here's an example of what can happen when companies fail to prepare for an eventual sale. A family-owned business started out in manufacturing, but over time it expanded into areas such as real estate, retail and technology. This had been a natural evolution, and some parts of the business began consuming more time and costs than they returned in profits.

When the company took a big financial hit following an adverse legal decision, its owners started thinking about selling off some or all of its assets. They hadn't planned for a sale and the unfocused nature of the company's operations and disordered financial records would likely make selling the company in whole difficult. The owners decided to spin off their real estate holdings and software patents to raise capital and refocus on their core business.

They hired an M&A advisor to help get these assets ready for sale, and ultimately were able to sell them for a fair price. But it required time and effort that would otherwise have been spent bolstering the business. Three years later, the company shut its doors.

Short- and long-term rewards

Even if you have no plans to sell, preparing for the possibility means that you probably won't be in a desperate situation should a sale become necessary. Take the time now to conduct a self-assessment, and then act on your findings. ■

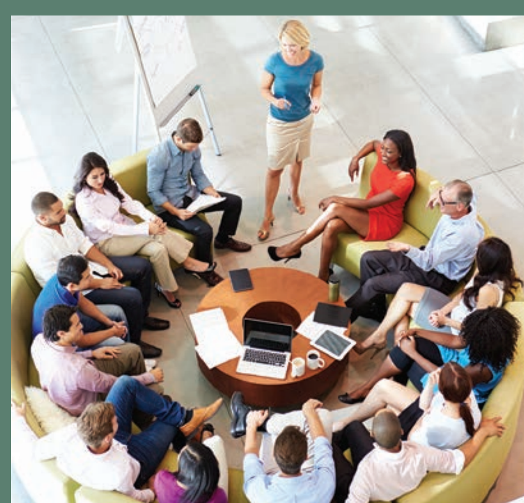
How to perform a "soft" assessment

Compiling company assets, debts and other "hard" measures is central to a comprehensive self-assessment. But don't forget to list the less-quantifiable aspects of your business. This "soft" assessment should highlight the cultural qualities that make your company unique. For example:

Management and employee relationships. How many employees is a typical manager responsible for? Are their relationships highly structured or informal? How and how often do managers and employees communicate?

Employee morale. What is your employee turnover rate? What reasons do long-tenured employees give for staying? How often and how quickly are employees promoted? Are they encouraged to critique established methods and initiate new projects?

Interdivision relationships. Do company departments and divisions work closely together, or does your company foster a competitive environment to encourage individual achievement?



Turn that frown upside down

MAKING A DISTRESSED ACQUISITION PROFITABLE

For experienced business buyers, turnaround acquisitions can yield big long-term rewards. But acquiring a troubled target can also pose greater risks than buying a financially sound business. That's why you need to ensure that you choose a company with fixable problems — and have a detailed plan to address them.

First things first

When seeking a turnaround opportunity, look for a company with hidden values, such as untried territories, poor leadership and outdated strategic plans that could be rejuvenated. Then decide if those opportunities mitigate your acquisition risks and potentially provide enough financial benefits. If you're financing the deal, your lender may also want to verify that the potential deal is sound.

Also ensure that you understand the target company's core business — specifically, its profit drivers and roadblocks. Without a clear understanding of this, you may misread the company's financial statements, misjudge its financial condition and, ultimately, devise an ineffective course of rehabilitative action. This is why many successful turnarounds are conducted by corporate buyers in the same industry as their sellers or by investors (such as private equity funds) that specialize in a particular sector.

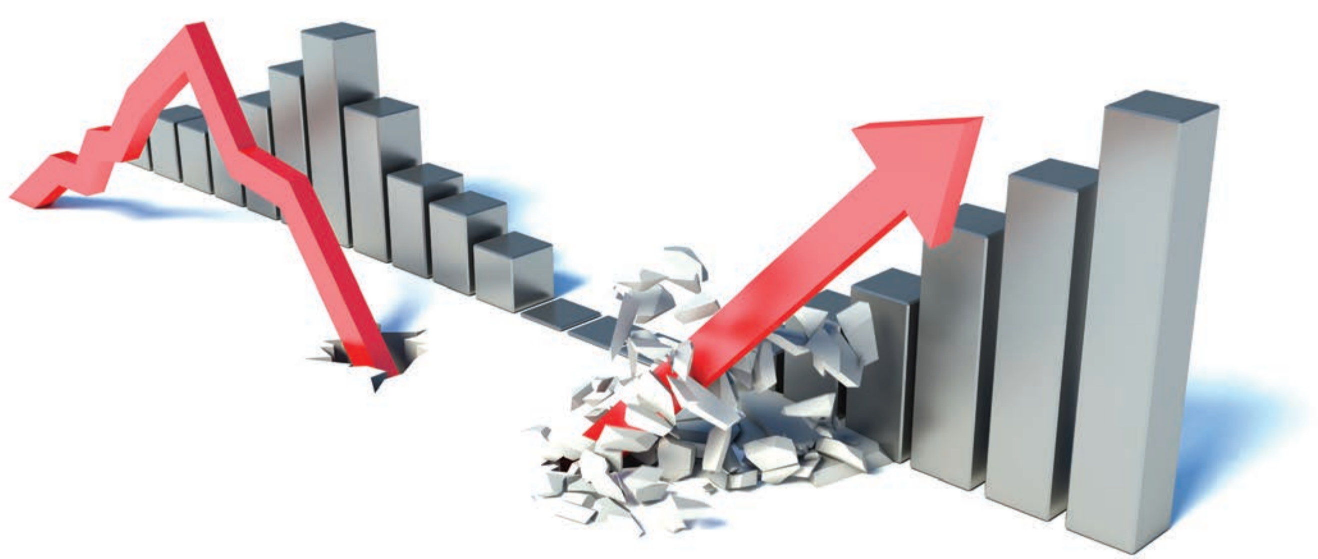
Verify the details

Due diligence is an important part of any acquisition, but it's the make-or-break stage of a turnaround deal. You should use this time to pinpoint the source of your target's distress (such as maturing products or overwhelming debt) to determine what, if any, corrective measures can be taken. Be prepared to find hidden liabilities — such as pending legal actions — beyond those you already know about.

However, it's also possible that you'll unearth potential sources of value, such as tax breaks or proprietary technologies. Benchmarking the company's performance with its industry peers' can help reveal where the potential for profit lies.

Proceed with a plan

Before you've completed your transaction, determine what products drive revenue growth and which costs hinder profitability. Does it make sense to divest the business of unprofitable products, services, subsidiaries, divisions or real estate? Should you cut staff?



Implementing a longer-term cash-management plan and forecast based on receipts and disbursements is also critical. You can manage each line item of your acquisition's weekly or daily receipts and disbursements in accordance with profit and loss projections, changes in working capital, and major debt and capital expenditures. With a strong cash-management plan and a thorough evaluation of accounting controls and procedures, you should be able to identify lost revenue opportunities, such as unbilled services. This plan can also help you determine where you might be able to cut costs.

All systems go

To run effective management reports, your accounting and reporting systems must produce the appropriate data. If these systems don't accurately capture all transactions and list all assets and liabilities, your management team won't be able to track progress and fully pursue growth opportunities or respond to potential problems.

One troubled manufacturing company, for example, wasn't tracking future purchase commitments. After the company was acquired, the new owner prepared and circulated among managers a comprehensive commitment and contingency report that helped senior management renegotiate terms of the customer agreements.

Mapping the future

Turning a financially distressed company around is a tall order, which is why you need a strategic plan that provides a map toward revenue growth and improved cash flow. Note that macro- and micro-level planning are equally important, as are short- and longer-term objectives. ■

Even small deals may face antitrust actions

Recently, a number of big-ticket mergers have collapsed in part due to regulatory concerns. Your M&A deal is unlikely to attract the same government and public scrutiny as Pfizer and Allergan's union (which stumbled in part thanks to new Treasury regulations) or the Halliburton and Baker Hughes merger. But there's no guarantee. Before you enter into serious negotiations with a seller, you need to ensure that your proposed transaction is unlikely to trigger antitrust enforcement actions from federal or state regulators.

Bust the myth

Many middle-market companies believe they're immune from antitrust challenges if their deals fall below the Hart-Scott-Rodino (HSR) $78.2 million threshold (as of 2016). After all, a transaction under that threshold doesn't involve making detailed filings with the Federal Trade Commission (FTC) and Department of Justice (DOJ) and then waiting for these agencies to determine whether the deal might adversely affect U.S. commerce.

The truth is, the FTC and DOJ have a history of challenging deals below HSR thresholds — even deals that have already closed. In 2014, the FTC won a court victory that allowed it to unravel a merger between a nonprofit health care system (St. Luke's) and a physicians' group (Saltzer Medical Group). That $28 million deal fell well below then-current

HSR thresholds and the organizations involved had been merged for two years at the time the transaction was challenged.

So it's possible for mergers between smaller, privately owned companies to face antitrust issues. After all, the FTC and DOJ have even cracked down during the past decade on deals in the $3 million to $5.5 million range.

Watch your step

The failed St. Luke's merger can prove instructive for participants in other smaller-scale M&As that want to avoid antitrust action. One objection to the St. Luke's deal was that it resulted in one company owning massive market share. After the merger, the company enjoyed an 80% share in the state of Idaho. The court ruled that such a situation allowed no room for new entrants into the market.

State exactly why the merger is being conducted and how the postmerger company will fit into its competitive landscape.

Provocative language also got St. Luke's in trouble. The merger parties used words such as "clout" and "dominance" in internal documents prepared for the transaction, and the companies projected that they could raise rates substantially after the merger. The FTC successfully argued that these documents suggested that the merging parties envisioned that their deal would result in vastly reduced competition.

Thwart potential threats

What can M&A dealmakers do to thwart potential regulatory threats to their deal? Consider the following:

Be clear about your deal's business purpose. State in writing exactly why the merger is being conducted and how the postmerger company will fit into its competitive landscape. Be specific about the deal's potential benefits, focusing on internal improvements. And avoid using overly expressive or subjective language about market dominance.

Stay within U.S. borders. One issue that contributed to the failure of the Pfizer/Allergan deal was that the merged company wanted to redomicile in a lower-tax country. If your company is considering a foreign buyer, or if your deal will relocate substantial parts of the business abroad, watch out.

Act to address presumptive challenges. If your merger will create a significant presence in a region or sector, consider selling off pieces of the combined operation to avoid regulatory scrutiny. This could mean selling particular stores or divisions as part of your M&A transaction.

Reach out to regulators — and legal counsel. Regulators at the state and federal levels offer business review procedures that could help you determine whether your deal is likely to attract attention. And if you believe your deal will meet antitrust challenges, consult an attorney who specializes in this area.

Be vigilant

Given the many moving parts that require your attention during a merger, you may be tempted to dismiss the potential for an antitrust challenge. But it's far better to assume the possibility and take steps to prevent it.

Ask the Advisor

Q. What is our role during due diligence?

A. Due diligence is an essential part of the M&A process — for both parties to a deal. Buyers need to confirm that the target company is what it has purported to be: that its financials are sound, operations align with financials, employees are committed and it isn't encumbered by legal liabilities. For their part, sellers must ensure buyers are satisfied with their findings.

Buyers asking more questions

These days, risk-averse buyers are assessing potential purchases with a sharper eye than they might have had prior to the 2008 recession. Some of the questions you'll want to ask are:

Is the company what it says it is? If your seller claims it's a leader in its industry, that it has a substantial pipeline of new products or that its client base is growing, it must substantiate such claims. Be wary of excuses and vague answers to pointed questions — they may be a sign of disorganization or, worse, mismanagement.

Are there any surprises? Your seller may have neglected to mention substantial debt obligations or potential legal issues. These don't necessarily have to kill a deal, but you should consider them when setting your offer price and planning postdeal integration.

Are stakeholders prepared for a new owner? In some cases, important customers or key employees object to the company's sale and threaten to leave when they learn about it. If you find this kind of resistance, personally communicate your plans and consider providing these stakeholders with incentives to remain loyal.

Sellers should tidy up

Prospective buyers are on the lookout for anything that might make their deals unprofitable. So sellers need to root out problems, clean up their balance sheets and anticipate buyer questions before due diligence begins.

One of the most important tasks is to ensure that financial statements are current. Future projections, particularly of earnings and profits, should be based on the most recent figures, which may be quarterly or even monthly. Also have several years of financial statements, and relevant legal and operational documents, ready for your prospective buyer's review. If you haven't already, get inventory reporting and other records in order so that you present a transparent, well-run organization.

Getting it right

Due diligence can be a challenging process. But if you play your role properly, you can avoid deal-spoiling mistakes. Preparation is critical for sellers, while buyers need to focus on asking the right questions and reviewing all documents thoroughly. ■

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 hundreds of 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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