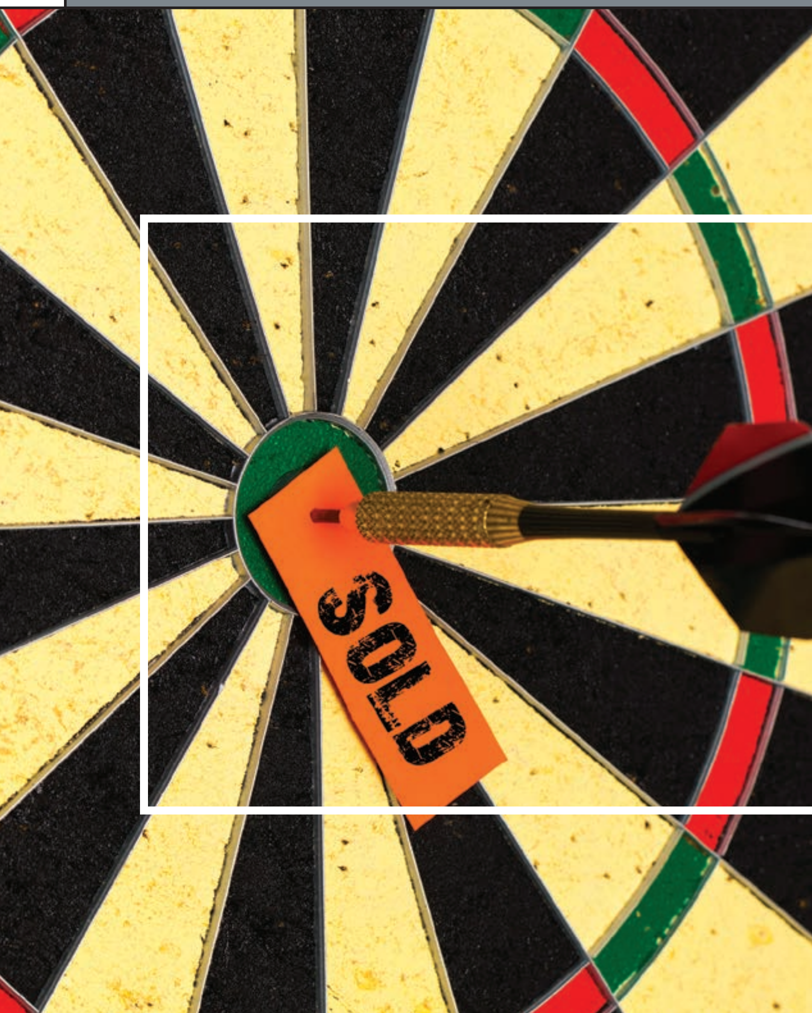
Merger & Acquisition Focus



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Going, going, gone
How targeted auctions promote successful sales

Let location be your company's X factor

Acquisition as reinvention
When a buyer's objective is change

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

Going, going, gone

HOW TARGETED AUCTIONS PROMOTE SUCCESSFUL SALES

Targeted auctions give business sellers some control over which buyers are allowed to bid on their companies. Here's how they work: A seller specifies the number of buyers allowed to bid and narrows the pool to qualified prospects — generally, buyers with strong strategic motivations and adequate financial resources to make an acquisition.

For in-demand companies, a targeted auction can simplify the process of selling. But such auctions also have drawbacks, such as a potentially negative effect on the ultimate purchase price.

Advantages for sellers

Sellers usually don't have the time and resources to secure competitive bids from a wide variety of potential buyers. Founders of smaller businesses, in particular, may be too busy with day-to-day operational demands to devote their attention to attracting and analyzing prospective bidders. A limited auction offers a more efficient and structured way to assemble a buyer pool.

Targeted auctions are also appealing to companies in niche sectors or that offer specialized services. Typically, these businesses have trouble attracting enough buyers on the open M&A market to encourage competitive bidding. A targeted auction helps them get the word out to interested buyers, including those that may not already have the selling company on their radar.

Approach anywhere from five to 40 buyers to assess their interest and motivations for making an acquisition.

Because it's easier to track a small number of prospective buyers, targeted auctions also help sellers limit access to proprietary information. What's more, there's generally less impact on the company's operations during the sale process. Due diligence can be conducted quickly and post-merger integration runs more smoothly when a seller has already "preselected" its buyer.

Making it work

If you're a seller who has decided to pursue a targeted auction, you will start by writing a confidential information memorandum to attract potential buyers. (See "Make your case with an information memorandum" on page 3.) You'll then approach anywhere from five to 40 buyers to assess their interest and motivations for making an acquisition.

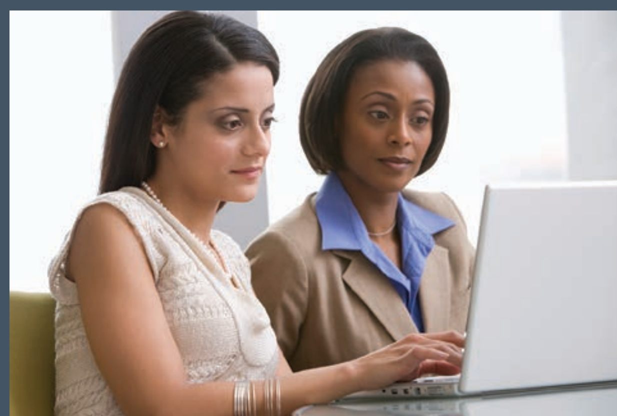
The advice and assistance of an experienced M&A advisor is essential here. Your advisor can help you cast your nets widely to find the best-qualified candidates and to assess the individual merits of

Make your case with an information memorandum

Sellers participating in a limited auction must prepare a confidential information memorandum (also known as an offering memorandum). This company overview is sent to buyers who have signed a nondisclosure agreement to protect confidentiality. The memorandum is required, but it also provides sellers with an opportunity to attract and encourage the kinds of buyers it wants.

To make a strong case for your company:

Keep it concise. Highlight key selling points — from best-selling products to technological innovations to the achievements of top managers. Answer any obvious questions (such as those related to performance anomalies) succinctly. Limit the length of your memorandum to 30 pages, or, even better, aim for 10.



Maintain a tight timeframe. Remember that this document is intended to hook potential buyers, so focus on the past three to five years. Interested buyers can request a more thorough company history later on.

Don't oversell. Highlight your company's strengths but don't exaggerate or make claims that you can't back up. Likewise, don't downplay weaknesses. Instead, address them as well as solutions to them.

each. Your advisor is likely to suggest you eliminate from consideration any potential buyer without the current financial means to make a satisfactory offer. You also want to set an offer deadline and cap participants at no more than 10. This enables you to separate the serious buyers from those just sniffing around for bargains.

Finally, conduct one-on-one negotiations with buyers on the shortlist. Give each buyer the opportunity to make a formal offer by an agreed-upon date.

Note some drawbacks

Despite the many advantages for sellers, targeted auctions aren't without risks. By restricting your buyer pool to a select few, you may reduce your chances of receiving an outsized offer from certain types of buyers, such as private-equity funds.

Another possible disadvantage is that, with a small group of buyers, each one is likely to be aware of the others' acquisition strategy and financial strength. A buyer could be more conservative in its initial offer and more aggressive in its deal terms if it feels confident that other bidders won't make a competitive counteroffer. Or the bidder might know that competing bidders will post higher offers with the intention of reducing them after due diligence is conducted.

Power of competition

A limited auction can make a business sale more efficient and lucrative. Such a system also provides sellers with a safety net. Should a buyer decide to change its offer during negotiations, sellers can always return to the auction pool to assess competing bids. But it's important to also be aware of the possible risks. ■

Let location be your company's X factor

The physical location of an acquisition target may seem like a minor detail for potential buyers. But in fact, location can drive an M&A deal and even help boost the sale price. If your company sits on prime real estate or you're located in a low-tax or low-regulation state, you may have underestimated its value. So as you enter the market, be sure to play up any location-related advantages that may attract prospective buyers.

Low-tax states

One significant enticement selling companies might offer buyers is tax savings. If your buyer is currently headquartered in a state with high municipal and state tax rates, the buyer could save substantially if it relocated its operations or headquarters to a lower-tax state.

If your business owns property in a hot real estate market, buyers might regard it as an appealing source of revenue.

The lowest-tax states, according to the research group Tax Foundation, are Wyoming, Nevada and South Dakota, which have no corporate taxes or individual income taxes. Such environments may provide enticements for relocating executives. Alaska doesn't have an individual income or state-level sales tax, and Florida and Texas don't impose an individual income tax. For their part, New Hampshire, Montana and Oregon are sales-tax-free.

Regulatory story

A reduction in regulatory burdens might also appeal to potential buyers. If your company is located in a low-regulation environment, you might encourage a buyer to move production facilities to your location and use it as a springboard for future development.

As you can imagine, much depends on the regulatory environment of your state. But many sellers can craft an appealing narrative wherever they're located. For example, Texas doesn't tax property used for pollution control, goods in transit or manufacturing equipment. Kentucky's governor recently announced a Red Tape Reduction Initiative, which is intended to minimize regulatory burdens on businesses, and Missouri has passed strong tort reform in a bid to reduce class-action lawsuits.

Also, there's a reason why more than 50% of public companies and 60% of Fortune 500 companies are incorporated in Delaware. For large companies, the state's reduced regulatory burdens and corporate and personal tax advantages are hard to beat.

Other factors

Many other factors come into play when buyers evaluate a seller's location and property holdings. For instance, consider geographic convenience. A buyer currently located in a landlocked state or in an area that lacks adequate airport, highway or railroad infrastructure may be interested in buying your business if it's located near a major transportation hub.

Upgraded facilities — for example, sparkling new offices or recently refitted factories — are always a plus. In fact, a buyer may agree to pay more for your company because it won't have to renovate offices or replace aging equipment. And if your business owns property in a hot real estate market where commercial property prices are consistently spiking, buyers might regard it as an appealing source of revenue. Your buyer could quickly fatten up its balance sheet by selling off your real estate at a profit.

If your property is located in a healthy real estate market, you may even be able to monetize it — before selling your business — via a sale leaseback. In such arrangements, a finance company purchases the property and leases it back (typically on a long-term lease) to your business. Or if you include real estate in the business sale, your buyer might want to conduct a sale leaseback to recapture invested capital or fund future growth.

Enhanced eligibility

Don't assume that location will be the most important consideration for buyers. No serious buyer will ignore poor financials, significant legal troubles, evidence of fraud or other serious issues simply because a company is well sited. But if your business is already a good M&A prospect, with attractive assets, strong growth and competitive advantages, location could be the factor that puts you at the center of a bidding war. ■

Acquisition as reinvention

WHEN A BUYER'S OBJECTIVE IS CHANGE

Not all business buyers think alike. So it's a mistake to assume that a prospective buyer is primarily motivated by the opportunity to add revenues or market share. In some cases, buyers make acquisitions to transform or "disrupt" their organization and alter the market's perception of it.

When faced with a prospective buyer bent on reinvention, sellers may need to customize their marketing pitch. And both sellers and buyers need to recognize that such acquisitions can pose postmerger integration and other difficulties. To ensure a smooth transaction, both parties should understand what to expect with this type of deal.

Transformative deals

There are several scenarios in which companies might use acquisitions to reinvent themselves. A big company with a stagnant market share might rejuvenate its business by buying a fast-growing

competitor with a more efficient supply-chain process. Or an established consumer-goods company with an aging customer base may seek a business with a younger target audience.

You don't have to look far to find real-life examples. Dell's recent $67 billion acquisition of cloud-computing provider EMC is intended to help Dell shift from an older business model reliant on hardware to cloud-based information technology.

A classic example of this same phenomenon is Time Warner and America Online's 2000 deal, which aimed to create a titan by merging traditional publishing and the then-new Internet. That merger's ultimate failure, however, provides a lesson on the risks inherent in transformative deals.

Buyers should question motivation

The right acquisition can positively transform a buyer's business processes — from human resources to supply chain logistics; research and development to information technology. Yet to avoid Time Warner/AOL's outcome, carefully consider several questions:

What needs to change in your current business? Are your key products losing market share? Is your central business model becoming obsolete? Is your client base in danger of diminishing? How do you expect an acquisition to realistically alter these trends?

What can we do better internally? Are there changes you can make — such as cutting costs or improving efficiency — that might have a similar transformational effect as an acquisition?

Do you really need a facelift? If, for example, your brand has been tarred with negative associations, buying a company and assuming its name may seem appealing. But do you have other options that aren't as risky?

A transformative deal may work if it can provide the fundamental change that your company can't achieve organically without incurring significant costs and disruption.

Sellers need to make the case

Sellers also need to play their part to ensure that a transformative deal will be successful. When marketing your company to a potential buyer, learn about its needs and objectives. If the buyer is seeking a "youth factor," you can demonstrate your social media presence and share demographic research. But be careful not to sell false promises if you don't actually have what the buyer needs.

A big company with a stagnant market share might buy a fast-growing competitor with a more efficient supply-chain process.

Also think about integration early in the M&A process. A transformative deal generally means that the buyer adopts many of its acquisition's business practices. So sellers should explain how the buyer might transfer processes and how the two companies might mesh after closing.

The Dell/EMC merger presents such an integration challenge. Dell is a traditional computer hardware business and EMC is a looser federation of sometimes-independent companies. For Dell to use EMC as a transformative mechanism, it may have to make major changes. The company's plan is to gain market share via integrated offerings of servers, cloud storage and PCs, and offer greater scale and a wider array of offerings than competitors such as Hewlett Packard Enterprise.

Know your limits

In the long run, an acquisition can be a lifesaving move for an established, yet stagnant, company. However, in the short term, the integration process may be painful. Both parties to a deal need to work to ensure that the match will be successful and that any challenges along the way are conquerable. ■

Ask the Advisor

Q. Do sellers always accept the highest bid?

A: Selling business owners usually favor buyers that offer the higher purchase price. But the most generous bid isn't always the determining factor in a sale — nor should it be. If your company is trying to make an acquisition but potential competitors have deeper pockets, don't get discouraged. Sellers, particularly founder-owned companies, generally also take other considerations into account.

Owner intention provides clues

An owner's postsale intentions can tell you a lot about the kind of offer that will be acceptable. Owners that want to remain involved with the company after the deal closes may not automatically accept the highest offer. If you offer a lower price than a competitor but a greater degree of collaboration, your bid may be more appealing. For example, a seller may welcome a board position, an equity stake in the company or the opportunity to stay on as an employee (perhaps temporarily).

If the financial difference between competing offers isn't substantial, a seller may prefer the prospective buyer offering a better strategic fit. If your company shares competitive space with the selling business or your management team already has a relationship with the seller, you could have the advantage — even if you don't have as much cash.

Some structures are more appealing

The structure of your offer may also influence your seller's decision. If an owner receives two similar-size bids, the smaller one from a buyer willing to pay all cash may actually have an advantage over a higher bid offering a mix of cash and stock options, or that requires the buyer to secure a bank loan. And cash typically trumps earnouts — where deferred payments are made to the seller based on the company's postsale performance. Some selling owners simply don't want to tie their business sale proceeds to a business they no longer control.

But other selling owners may actually prefer a stock sale over cash because cash can create a substantial tax burden for them. In such cases, the seller may accept a lower stock-only offer over a higher cash-only bid.

It's about relationships

In most cases — particularly when all other factors are relatively equal — sellers prefer the highest bid. But serious buyers with well-heeled competitors shouldn't give up. Like other business transactions, M&As are rooted in human relationships. So arrange a meeting with the selling owner, find out what he or she wants from a deal, and try to negotiate something that works for both of you. ■

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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