Merger & Acquisition Focus

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Selling isn't an owner's only liquidity option

Don't let compensation disparities drag down your deal

Ask the Advisor

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Innovation vs. maturity: The choice is yours

Acquisitions of innovative start-ups tend to grab the headlines, but many business buyers prefer to target mature companies that promise dependable revenues. Each choice offers advantages and potential pitfalls, and buyers need to carefully consider their objectives before starting their search.

Sellers also must ask the innovation vs. maturity question. Specifically, they need to identify their position on the spectrum so that they can successfully market their company and find the right buyer.

Why buyers want new ideas

Buyers typically seek young companies for one or more reasons, including:

Lower purchase price. A start-up with a low market valuation or minimal expenses can be relatively cheap to acquire. Buyers often pay for such deals in cash to avoid the hassle and cost of bank financing or because the young company may not yet be eligible for traditional debt.

R&D alternative. Rather than devote capital to expanding its own research and development efforts, a buyer can externalize early development costs and risks with a start-up that has the necessary products and talent.

Shot in the arm. Start-ups also may appeal to buyers that want to rejuvenate their own mature operations. Sellers with a toehold in newer sectors or even foreign markets can be particularly appealing.

Why buyers want experience

Mature companies, on the other hand, tend to attract buyers that want a steady revenue stream to bolster their bottom line. They value such features as established product lines with dominant market share and longtime customer bases. Such buyers are more focused on immediate benefits — as opposed to growth potential — and are likely to appreciate turnkey opportunities. Because easy integration is important, they typically try to acquire a culturally compatible company.

But buyers also need to watch out for common mature-company pitfalls, such as a declining business model or lack of new products in the development pipeline. Mature companies are also more likely than start-ups to have obligations such as bank debt or ongoing employee benefit costs.

How to sell ambition

When it comes to selling on the M&A market, start-up businesses need to position themselves differently from mature companies. For example, when making initial

These days, innovation means IP

The value of many start-ups rests on their intellectual property — patents, copyrights, trademarks, trade secrets and licenses. So if you're targeting this type of business for acquisition, be prepared to conduct thorough due diligence on intangible assets.

Start by identifying key technologies, processes or products the company has developed or uses. Then examine which patents have been issued and whether they protect key technologies or only minor aspects of them. If the latter, competitors may be able to bypass patent protections.

Copyrights harbor similar risks — for example, if a company has failed to ask developers to sign agreements that release their rights. Without such agreements, the work product belongs to the contractor, and you may have to pay a fee to use it. Trade secrets and licenses may have similar issues. If you don't have in-house expertise, work with knowledgeable M&A advisors and attorneys to ensure you get what you pay for.

contact with a potential buyer, a young company should emphasize such qualities as its:

- Pipeline of new products,
- Intellectual property and goodwill,
- Promising R&D operations,
- Cutting-edge technologies, and
- Marketing advantages over mature companies, such as a large social media presence or a reputation as being the "next big thing."

However, even young companies should be prepared to make a case for their business savvy and ability to go the distance. Buyers are increasingly attuned to the risk of acquiring a business with lots of ideas and little to show for them. A solid business plan and financial projections can help a seller show that its model is sustainable over the long term. M&A advisors, who understand what buyers look for, are critical at this juncture.

One other issue: Most start-ups are staffed by people whose ambitions probably outweigh their experience and most established companies are run by experienced people who may be less receptive to new ideas. Sellers should indicate their willingness to adapt to new expectations and a more structured environment.

How to market longevity

Companies that land on the mature end of the innovation vs. maturity spectrum have several marketing advantages — even in an M&A environment that celebrates start-ups. These types of sellers can emphasize their experience and longevity, including the ability to survive and thrive in difficult economic conditions. A company history not only demonstrates how a mature business has handled market contractions, but also its resilience when confronted with challenges such as a new sector rival or the loss of a major customer or key supplier.

Even though experience is a mature company's main selling point, these sellers can't afford to ignore innovation. They should also highlight prospective products or market opportunities that a buyer with capital and other resources could bring to fruition.

Good match

For buyers, the choice between innovation and experience is often clear. Companies in a strong competitive space may be able to take a chance on a start-up. Those that need a reliable source of revenue should probably look for an established business. As for sellers, they should learn as much as possible about potential buyers' objectives to help ensure a good match. ■

Selling isn't an owner's only liquidity option

An outright sale isn't the only option for business owners who seek liquidity. If you need to raise cash yet still want some control over your business or hope to transfer it to your managers or family members, a leveraged recapitalization may be an option. Depending on the form of leveraged recap, you could remain at the helm or enable your successors to assume ownership.

Not ready to give up control?

Leveraged recaps take one of two forms. The first is when an owner partners with a private equity (PE) group to share ownership. This method typically is preferred by owners who aren't yet ready to give up control of their company.

In a management buyout, managers borrow money to redeem the principal owner's shares or pay an extraordinary dividend.

When you partner with a PE group, it buys a portion of your equity — usually between 60% and 80%, but possibly as much as 100%. The PE group usually includes debt as part of the finance structure to reduce its out-of-pocket cost and to secure a portion of its principal investment in the event your company fails. PE investors finance their acquisitions with a combination of funds from their general investment pool and senior and subordinated bank debt. They usually intend to sell their investments within five to seven years.

A PE group will have input into your company's major strategic decisions and may attempt to realize synergies with your company and others in its investment portfolio through, for example, shared sales and marketing resources. But it's likely to be hands-off when it comes to day-to-day operations. In many cases, private equity groups depend on the experience and expertise of a company's existing management team. Your team will be expected to have some kind of equity investment in the business and may receive further performance incentives in the form of equity options.

Because private equity groups eventually sell their ownership interests — generally to another private equity group or a strategic buyer, but possibly as an initial public offering — this structure may not be the best option if you want to keep your business in the family. Also, the most likely candidates for private equity investment are higher-growth companies.

Wary of outsiders?

Leveraged recaps can also take the form of management buyouts. In this scenario, a company's

managers borrow money to redeem the principal owner's shares or pay an extraordinary dividend.

If you're concerned about giving up control to outside investors or placing a sell-by date on your company, consider offering your management team a chance to buy you out. The team may be able to finance its equity acquisition with a combination of personal funds and bank debt, borrowing against the business's assets and cash flow. Management will be personally responsible for repaying any senior debt. If more funds are needed, subordinated debt also may be available.

This type of leveraged recap, however, isn't appropriate for every business. Companies need a strong management team that's financially and emotionally committed to the future of the business. They should also have a history of profitability, low debt, solid growth potential, predictable cash flows, adequate collateral and low future capital expenditure requirements.

If you and your management team choose this type of transaction, your company will be highly leveraged. This can make it vulnerable to general economic or industry downturns, so fiscal responsibility is essential. Also, it may be difficult to find additional financing for future growth ventures.

How to choose

The viability of either leveraged recap method depends on many factors. These include your liquidity objectives, your management team's commitment to the future of the company, your family's interest in running it and your business's general financial health.

You also need to consider personal issues. For example, how involved would you like to be in your business's future? How much retirement income will you require? What are your estate planning goals? Answers to these questions — and input from your advisors — will help you make the best choice. ■

Don't let compensation disparities drag down your deal

One of the many seemingly minor issues that can become a big deal during an acquisition is the compensation of key employees. If either newly acquired or long-time employees are unhappy with the compensation decisions you make now, it has the potential to upset the integration process. So it pays to address compensation issues early in the M&A process — and to resolve them before your deal closes.

Recognizing differences

It's actually quite common for an acquisition's management and key employees to be compensated at higher rates than those in the buyer's organization. A target also may offer financial incentives to rank-and-file workers while the buyer offers them only to a limited group of elite employees.

There are several reasons for such disparities. Target companies usually are smaller and younger than their buyer, and generally place more responsibility in fewer hands. Start-ups, in particular, typically reward employees with stock options and similar financial incentives. What's more, start-ups often "poach" key employees from their rivals, luring these key employees with hefty paychecks.

Let's say your company pays its senior employees with six years' experience between $100,000 and $120,000 and you're in the process of buying a business whose employees with similar experience earn between $130,000 and $150,000. If, to equalize compensation of the two groups, you reduce the acquired employees' salaries, your new employees are likely to cry foul and start looking for a new job. Even if these people remain to help with postmerger integration, they'll have little incentive to work hard during a difficult period that's critical to the success of your deal.

Finding solutions

It may seem like you're between a rock and a hard place. Either you disappoint and alienate your acquisition's employees or anger your own. But there are ways to bridge compensation gaps and keep everyone happy.

Start by bringing your target's employees into the conversation before your deal is final. Explain the situation and let them know that you welcome suggestions for achieving better compensation parity between the two employee groups.

Also propose your own ideas. For example, you might offer to reclassify nonmanager key employees as managers to justify their pay scales. Tie such promotions to new supervisory or other duties and review the new managers' performance in six months. If you're disappointed in what you see, reduce their salaries accordingly.

Or treat their current higher salaries as incentive pay. To retain their premerger compensation levels, employees might be asked to fulfill a set of tasks in a specified period. These could include raising their productivity by a certain percentage, increasing client numbers or mastering new skills in the next year. If they don't meet these goals, their pay levels will fall.

Note that your current employees will almost certainly hear about any incentives given to newly acquired employees. So you need to consider offering them the same opportunities — including pay hikes — as you offer your target's key people.

Looking for alternatives

What if offering greater compensation for employees performing similar jobs isn't feasible for your company due to cost or other factors? Acquired employees may be willing to accept valuable benefits in exchange for a pay cut.

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For example, your company may have a more generous health care plan with lower premiums or deductibles than the target company offers. Or you may offer a larger match for 401(k) plan contributions. Many employees accept additional vacation and other types of paid time off, such as sick or parental leave, in exchange for salary.

Tackling the challenge

Make no mistake: The wrong compensation policies can damage your deal, possibly irrevocably. The sooner you start thinking about these issues and looking for solutions that will satisfy all of your employees, the better. ■

Ask the Advisor

Q. How will Brexit affect my cross-border deal?

A. If you're planning to merge with a U.K.-based company, that country's June 2016 vote to exit the European Union (Brexit) could affect your transaction. Indeed, the long-term ramifications of that decision may make you want to think twice about your proposed merger.

Right now, however, most of the business community is waiting to see how the political process plays out. Britain is scheduled to leave the European Union in the spring of 2019, but it's possible that it won't leave until the early 2020s, and there are indications the transition may take even longer.

Period of uncertainty

Here's another wrinkle: Even if Britain leaves the European Union, it may not leave the internal market — the free trade area that includes such non-EU countries as Norway. In fact, most experts believe that the United Kingdom will negotiate to stay in that market, which would minimize the impact on cross-border deals between U.K. companies and other EU-market countries.

Even so, any deal involving a U.K. company now must contend with an extra element of uncertainty. If your proposed deal is part of a strategy to gain access to the EU internal market, Brexit may throw a wrench into your plans.

Longer-term changes

Assuming that Brexit comes to pass, potential long-term effects include:

Greater protectionism. Britain might adopt a more vigorous antitrust regime that would step up government intervention in many sectors. This could make it more likely that the government would block foreign purchases of U.K. businesses.

Enhanced regulations. Currently, notifying the country's Competition and Markets Authority (CMA) of an intended merger is voluntary (though it's generally in a company's best interest to file). Post-Brexit, that notification — and possibly other formalities — could become mandatory.

More paperwork. If your acquired company has revenues from both EU and U.K. markets, you may have to report to both the European Commission and the CMA in the future. Previously, one filing sufficed.

New strategies

Post-Brexit, a merger with a U.K. company could take more time and trouble than you originally anticipated. And there are still plenty of unknowns. For example, will a trade war break out between Britain and the European Union? Could Brexit cause an economic downturn throughout Europe?

Forecasting such events is difficult. So if your company's intention is to secure a foothold in the European Union, you may want to consider merging with a company in a country that still belongs. ■

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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 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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