Merger & Acquisition Focus

Year End 2014

The promise — and perils — of inversion deals
Why everyone's talking about these cross-border mergers

Attract new investors with your business plan

What's their motivation?
One simple question can yield a wealth of information

Ask the Advisor

Celebrating Over 25 Years

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The promise — and perils — of inversion deals

WHY EVERYONE'S TALKING ABOUT THESE CROSS-BORDER MERGERS

Corporate inversions have become the dominant means of making cross-border mergers — representing the majority of U.S. outbound deals announced in 2014. The basic premise of this type of transaction is that a buyer in the United States reduces its global tax exposure by finding a seller in another country with a lower corporate tax rate. Then the buyer "domiciles" itself in the seller's country, either setting up new offices or taking over the seller's facilities.

If your company is considering a cross-border merger, inversion methods could help you achieve strategic objectives while lowering your tax exposure. However, inversion deals are controversial enough that President Obama and many congressional leaders have spoken out against them.

Growing wave . . . of controversy

As of June 30, inversions accounted for 66% of 2014's proposed U.S. outbound deals, according to Thomson Reuters. That's up from just 1% in 2011. Many recent deals have been made between pharmaceutical manufacturers, but other buyers include media companies and manufacturers.

The merits of inversion deals have been debated for years. But the practice came to the attention of the general public when Burger King proposed an $11 billion acquisition of Canada-based Tim Hortons, a coffee-and-doughnut chain, this past summer. As part of the deal, Miami-based Burger King would move its corporate headquarters to Canada, which offers a lower corporate tax rate. Burger King management claimed that the move wasn't a tax ploy but instead was designed to improve the chances that Canadian regulators would approve the deal.

If a buyer's customer base is already primarily in its target company's country, it can make sense to relocate via merger.

Big savings

A primary allure of inversions is potential cost savings due to reduced tax exposure. Once domiciled in a new country, companies don't have to pay the U.S. statutory tax rate of 35% on foreign earnings. What's more, they can use cash from foreign sales without being subject to the high repatriation tax they'd pay as a U.S.-domiciled company. When Cleveland-based Eaton Corp. acquired Ireland's Cooper Industries and relocated its headquarters to Ireland, Eaton stated that it expected to save $160 million a year.

There are other strategic reasons to do an inversion deal. As in Burger King's case, an acquiring company may relocate to reduce its chances of coming afoul of antitrust laws. And occasionally, an inversion represents the culmination of a long-term

Are you ready for new risks?

If your company is planning a cross-border inversion deal, get ready to contend with a broader and possibly more intensive set of risks, including those associated with:

Overseas regulations. A U.S.-based company domiciling in its acquisition target's country will have to comply with new government regulations. Before making the deal, learn what they are, whether compliance will be difficult and costly, and whether regulations change often or are progressively becoming more onerous.

Official corruption. Does the target company's country have a history of corrupt business practices? Find out whether your company will be pressured to pay government officials for favorable access or tax treatment.

Stateside reputation. By moving overseas, your company could take a reputational hit back home. It's possible that politicians, not to mention competitors, will publicly demonize your company as a "tax evader" or "job killer."

Political pressure. If inversions become more common, pressure is likely to grow on Congress to limit them. This could lead to new regulations that reduce your company's ability to redomicile or, worse, invalidate a move that's already complete.

strategic shift. If a buyer's customer base is already primarily in its target company's country or economic region, it can make sense to relocate via merger.

Government pushback

To avoid losing tax dollars, the IRS has proposed a rule that would require corporate buyers to already have at least 25% of their assets, income and employees in the country to which they're moving. Also, foreign-owned sellers would have to be worth at least 20% of the value of their purchaser. (This latter provision is intended to end the practice of U.S. businesses merging with shell companies in so-called tax shelters such as Bermuda.)

Some legislators have called for an increase in these percentages, but others have proposed instead cutting U.S. corporate and repatriation tax rates to level the playing field. Considering that U.S. nonfinancial companies held nearly $950 billion of cash overseas at the end of 2013, avoiding the repatriation tax alone could be enough incentive to justify the headaches of moving headquarters across borders.

In September, the Treasury Department announced new regulations intended to reduce the tax appeal of inversion deals. They would strengthen requirements that U.S. companies own less than 80% of the combined company to benefit from the other country's lower tax rates.

Weighing your options

Given the risks involved in inversion deals (see "Are you ready for new risks?" above), such transactions aren't for every business buyer. But for certain companies — for example, those that earn large amounts overseas and face substantial tax burdens for repatriated earnings — an inversion deal could be worth the challenges involved. ■

Attract new investors with your business plan

If you think business plans are only for young companies seeking initial financing, think again. A business plan can also help established companies make strategic decisions and communicate with lenders and investors when they seek new capital infusions.

A good plan that clearly and succinctly outlines the company's purpose, profitability, industry, competition, management and personnel generally takes between four and eight weeks to prepare. Pulling together accurate financial projections often is the most difficult business plan–related task for management, but such financials are critical to attracting new investors — including business buyers.

Both broad and focused

Your plan should provide its readers with a realistic perspective of all aspects of your business operations. This includes details about:

- Product and service offerings,
- Market factors and strategies,
- Industry trends,
- Competitors,
- Management and staffing,
- Pricing and marketing strategies,
- Business risks and what might mitigate them,
- Strategic and financial goals, and
- Historical financial statements and a financial forecast.

While the purpose of your plan may dictate its length and level of detail, the best business plans generally are concise and targeted to their specific audience.

For example, lenders are concerned about your ability to repay loans. Therefore, a business plan targeting lenders should focus on financials — showing adequate collateral, a history of steady cash flows and an ability to reach future financial objectives. The plan should also specify loan requirements, how your business intends to use the funds and how it plans to repay them. Private investors will be concerned with all facets of your business.

Calling new investors

When addressing potential investors, your business plan should specify three important things:

1. How much equity are you offering in exchange for what amount of money?
2. How will your business use the money?
3. What return on equity can investors expect?

Major investors typically put a high premium on the experience and quality of a company's management team, looking for individuals with a history of successfully implementing a business plan in the specific market and achieving financial goals. Investors will also be interested in your market research and analysis of business opportunities. So be sure to discuss potential barriers to bringing your products to market, such as government regulations, competing products, disruptive technologies, raw material costs and high product development costs.

Financial statement projections can show that you understand how your ideas translate into tangible results.

The information conveyed in your plan is crucial for an investor's valuation of your company and the terms and conditions necessary to attract additional funding. If, for example, your business's most valuable asset is its intellectual property, you need to convincingly convey the value of patents, licenses, trademarks and trade secrets.

Future financial result

Financial statement projections can show that you understand how your ideas and objectives translate into tangible results. While a certain amount of detail is important in substantiating the projections, don't add too much detail in your business plan. The finer details often are best discussed during face-to-face meetings. These personal interactions between management and investors will showcase your understanding of the business.

Even if you draft your basic business plan internally, consider engaging outside advisors to prepare financial statements. (Note, however, that it's never a good idea for a business to allow outside advisors to write the entire business plan without significant input from management.)

Exit strategy

Not only will your business plan help you communicate with lenders and investors, but it will also come in handy as a comprehensive overview when you decide to exit your business. In fact, consider including your exit strategy — whether it involves selling to another company, selling to your management team or passing your business to family members — in your business plan. Even if your plans change over time, including an exit strategy in this important document helps to promote stability and value. ■

What's their motivation?

ONE SIMPLE QUESTION CAN YIELD A WEALTH OF INFORMATION

When business buyers first meet with the owners of a potential acquisition target, almost no question is more important than, "Why are you selling?" Usually the answer provides insight into the company's operations, culture and even its future performance. The same goes for sellers. A buyer's impetus can tell the seller everything from how much it's willing to pay to how it will handle integration.

From the mouths of sellers

Owners may be motivated to sell for clear and generally justifiable reasons. But there's also the possibility that owners are hoping to get out before their company's deeply entrenched problems become apparent to potential buyers.

If, for example, a company is being sold by a founder who's itching to launch a new business

venture, a buyer might assume (until there's evidence to the contrary) that the first venture was successful. Illness or a desire to retire are other reasonable motivations to sell.

If a seller seems frustrated about being unable to move the company beyond a certain stage, it isn't necessarily a red flag. The right buyer with more experience growing a company or better access to capital might be able to get the stalled business going. And the fact that its owner recognizes current limitations suggests that the business has been ably managed.

Other answers to "Why are you selling?" may warrant caution — for example, if a seller is evasive and seems anxious to unload a company that doesn't otherwise seem prepared for the M&A market. Even if historical financial statements check out, the seller may have information about new competition, pending regulations or imminent product obsolescence. Hints of mismanagement, fraud, major legal liabilities or severe financial distress may warrant reconsidering the deal altogether. And if a previous M&A transaction fell through, buyers should investigate the reasons before proceeding.

What buyers are saying

What motivates a prospective buyer can help a seller determine whether it has found "the one" or should keep looking. For example, a financial buyer that claims it's seeking a bargain is probably less likely to pay top dollar for an acquisition. On the other hand, if a selling company is distressed, a financial buyer with experience turning around struggling businesses may be the most likely to pay a fair price.

Buyers just looking for a steal can be screened out before a face-to-face meeting takes place by working with experienced M&A advisors. Buyers that indicate they're only after a business's assets, not in maintaining current operations or retaining long-time employees, also might be cause for concern.

Buyers usually pay higher prices for companies that have something they need — for example, unique products, valuable intellectual property or a key sales territory — to achieve strategic objectives. Such motivations can give a seller the upper hand when it comes to price and concessions.

It's possible that owners are hoping to get out before their company's deeply entrenched problems become apparent to potential buyers.

Many of these types of buyers make multiple acquisitions, so sellers should find out how the buyer's prior deals fared. If acquired businesses were kept as separate units, how have they since performed, financially and competitively? If acquisitions were fully integrated into the buyer's company, how many original employees are still around?

Fact-checking claims

Your buyer's or seller's stated motivations can be a great launching point, but be sure to follow up on any claims. In addition to performing financial and legal due diligence, consider running background checks on the company's principals and talking to a sampling of employees, customers and vendors.

Questioning your counterpart's motivations is an important part of the due diligence process. It helps you understand the other party's mindset, which can make a big difference at the negotiating table. ■

Ask the Advisor

Q. When during the sale process is my deal most vulnerable?

A. Any M&A deal experiences tensions — regardless of how well negotiations seem to be progressing. But sellers should keep in mind that at certain points during the transaction the sale is more likely to unravel. You need to be especially vigilant during these times, taking seriously any disagreement that could become a deal-killer. Better yet, address the issues before you even arrive at these stages of the transaction.

Vulnerability #1: Initial meeting

Until you and a prospective buyer actually meet and due diligence is underway, your company exists only in the abstract for a buyer. You're an appealing prospect that looks good on paper. But buyers know that your business's actual operations, financials and people may end up looking less attractive in person.

To avoid disillusioning a prospective buyer, know your company's shortcomings and be transparent and honest about them — on paper and in person. If several members of your management team are ineffective or a unit is underperforming, be upfront and explain how you're working to change that. You might, for example, discuss plans to replace the weak executives and explain how you're paying down or refinancing loans.

Vulnerability #2: Price negotiations

Negotiations over the purchase price can be fraught with tension. Some sellers feel insulted by their prospective buyer's initial offer, while buyers often get frustrated when a seller insists on a price that's far above what the buyer believes the business is worth.

You can reduce the chance of conflict by first discussing your pricing strategy with your M&A advisor. Understanding your counterpart's valuation approach will help you respond more objectively. Don't sit down at the negotiation table and announce your minimum expectations. Instead, with a price range in mind, maintain a clear, consistent message throughout negotiations. Remember to remain flexible and realistic. Pushing for a price that earnings and assets don't support will likely lead to disappointment.

Vulnerability #3: Due diligence

The final weeks before you close can be nerve-wracking. You may worry that your buyer will turn up negative information that merits a new round of negotiations — or even destroy the deal.

Your buyer is almost certain to uncover any legal liabilities or less-than-stellar financial records. So bring them up before due diligence begins.

Smooth the way

There's a chance that a serious conflict will develop during the sale of your business. Fortunately, you can predict the rocky stages of your transaction and smooth the way before you get there. ■

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Celebrating Over 25 Years

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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