Merger & Acquisition Focus

Year End 2006

Options for taking your company public

Brief and to the point
Drafting an effective letter of intent

Enterprise value
How smart buyers view company debt and cash

Ask the Advisor

Options for taking your company public

If you're looking to raise cash or exit your business, you aren't limited to a standard merger or acquisition. Going public — through an initial public offering (IPO), reverse merger or "Reg. S-B" — is another option. While becoming a public company involves time and expense, it also offers many advantages.

Initial public offerings

IPOs generally are considered the best way to go public — or trade your stock on a national exchange to the general public. The process requires the assistance of experienced professionals and involves many steps including:

- Drafting a prospectus that fully describes the company,
- Registering with the Securities and Exchange Commission (SEC),
- Obtaining the SEC's approval of the prospectus,
- Finding one or more investment banks to market shares to investors, and
- Choosing an exchange on which to list.

New public companies can choose among nine U.S. stock exchanges, each with its own listing fees, rules and requirements. The New York Stock Exchange and NASDAQ are the two largest. For smaller public companies that don't meet the listing requirements of these, there are two over-the-counter (OTC) markets — the OTC Bulletin Board (OTCBB) and the Pink Sheets — that can help match buyers and sellers of small-company stock.

IPO advantages and drawbacks

There are several compelling reasons to go public by listing on a national exchange. Because it offers a continuous buying and selling market, the net proceeds of an IPO can become a permanent source of capital. If successful, your company can later issue stock for acquisitions, or to raise funds for capital expenditures and other strategic initiatives.

Also, because public companies tend to be valued more highly than private ones because of their national exposure and potential liquidity, stock prices may continue to rise. Further, stock options or actual shares can help retain valued employees and attract new talent.

The benefits of going public, however, should be weighed against the costs and risks. Legal and investment banking fees are a substantial expense: 7% or more of the shares sold. And complying with SEC regulations — for financial disclosure, auditing and corporate governance, particularly since Sarbanes-Oxley went into effect — can be a burdensome ongoing expense. Finally, if a public company suffers financial reverses or the overall stock market declines, your company's stock price will probably suffer.

Reverse mergers

If you wish to avoid the expense and delays that often accompany an IPO, you might consider a reverse merger. With this option, you buy control of a "shell" company — typically a public company that has ceased operations due to bankruptcy or another event. Your company then merges with the shell and, in the process, becomes public.

The costs of a reverse merger primarily involve legal expenses and the purchase price of the shell's stock. But these typically are substantially less than the cost of an IPO.

On the other hand, while this procedure is faster and less expensive, you don't raise net proceeds as you would with an IPO. And if you merge with a shell that's traded over the counter, you may have trouble attracting enough investor interest to cause notable stock appreciation. Many OTC companies simply are too small, or don't provide adequate, audited financial information about their results to appeal to most investors.

Finally, you may acquire unexpected environmental or legal liabilities associated with the shell company. These, however, can be avoided by buying a clean shell — a public company created specifically to be acquired in a reverse merger.

Small business stock offerings

Another option for smaller businesses interested in going public is a Regulation S-B registration. The registration forms are much shorter and less expensive than the larger-company forms, and required ongoing financial reports are less onerous. To qualify, a company must have under $25 million in annual sales and public stock worth less than $25 million.

Reg. S-B companies are too small for NASDAQ listing, but may qualify for the OTCBB or Pink Sheets. You could, however, find it difficult to generate much buying interest in the shares unless you have a compelling story such as skyrocketing sales or a hot new product.

Making a choice

If you're considering selling shares to the public, talk to an attorney who specializes in securities law and financial professionals experienced in taking companies public. Stock sales are subject to state and federal laws and regulations, some of them highly complex; penalties for violating securities laws can be severe, including fines and/or prison.

Your advisors also can help you explore alternative funding strategies, including Small Business Administration loans, venture capital and bank debt. Before making the decision to go public, carefully review your options.

What's the difference between registered and exempt offerings?

U.S. corporate law recognizes two methods of selling securities to investors:

1. Registered offerings. These include initial public offerings (IPOs) registered with the Securities and Exchange Commission (SEC) and listed on a national exchange, as well as Regulation S-B offerings. Secondary offerings by listed companies are also registered. Companies with registered shares must periodically provide independently audited financial reports to the SEC unless they drop under certain limits involving the number of shareholders and total assets.

2. Exempt offerings (also called private offerings). These aren't required to register with the SEC, but they're subject to federal antifraud provisions and possibly state securities laws. Stocks sold through exempt offerings may be quoted over the counter on the Pink Sheets, but not on the OTC Bulletin Board (OTCBB), which is for registered securities only.

Federal securities laws allow a variety of exempt offerings, but they're all subject to limits involving business location, number and value of shares, number and type of shareholders, intrastate selling, and corporate assets. Because they can't trade on national exchanges or the OTCBB, exempt shares generally attract less investor interest than registered shares.

The SEC provides an overview of registered and exempt offerings written especially for small business owners at: http://www.sec.gov/info/smallbus/qasbsec.htm.

Brief and to the point

Drafting an effective letter of intent

A letter of intent (LOI) can make or break an M&A deal. This nonbinding document — designed to protect and meet the needs of both buyers and sellers — allows due diligence and other crucial transaction stages to go forward with a shared acknowledgment of the proposed terms of the deal. Without buyer and seller agreement on the terms of the LOI, chances are your transaction will never reach completion.

Opening the door to negotiations

An LOI, also known as a term sheet, is a relatively short document drafted by a prospective buyer and usually cosigned by the seller to acknowledge agreement with the buyer's basic terms for purchasing the business. Although the LOI isn't legally binding, it opens the door to the negotiating process. When well crafted, an LOI assures the seller that the buyer is serious, is willing to pay a fair price, has a reasonable financing strategy and won't require onerous terms and conditions. Ultimately, it saves the parties time and money.

The LOI is drafted before the start of due diligence — the stage at which a buyer verifies that the company is worth the proposed purchase price. After due diligence is completed to the buyer's satisfaction, agreement can be reached on outstanding issues such as the final price, owner financing and the closing date, and the purchase and sale agreement can be signed. Generally, it's to the buyer's advantage to draft and sign an LOI as quickly as possible to head off serious bids from other interested parties.

Elements of the letter

The content of an LOI will vary depending on the transaction, but letters generally contain several standard features. Perhaps most important is a description of what's being purchased — assets or company stock. The offering price also may be specified, along with the method of payment, such as cash, debt, stock or a combination of them. Typically, an LOI will discuss which liabilities, if any, the buyer intends to acquire.

Most LOIs contain details about the financing strategy, which could involve using the assets of the business as collateral. Other terms may be spelled out, such as how the price will be revised if the financial condition of the company changes before the deal has closed.

Contingencies are an important component of an LOI, particularly those dealing with due diligence. You should reserve the right to back out or revise the price if significant issues are uncovered during the due diligence stage or you discover that the seller has failed to make important disclosures.

Time limits often are specified for the closing — either a specific date or a time period, such as 45 days after due diligence is completed. And an LOI might include sections on representations, covenants, warranties and indemnifications.

Understand your seller

You should approach an LOI by trying to understand the seller's motivation and position. For example, if you know the seller is looking for a quick sale, you might request as short a due diligence period as prudently possible. You might even consider forgoing a "no shop" clause, which prohibits the seller from inviting offers from other bidders, if you feel you can finalize the deal fast enough to preempt other buyers.

Don't specify such a low selling price that you risk offending the seller or not being viewed as serious about your acquisition. And to the extent you have financing flexibility, base your offer on as much cash as possible, as opposed to heavy debt financing. You also can offer to put a large deposit in escrow, making sure it's refundable in full.

Maintain flexibility

While ensuring that all key points are covered, keep your LOI as brief as possible. Presenting the seller with too many conditions can be counterproductive because it may seem like you're imposing nonnegotiable demands rather than general guidelines.

It's important to let your seller know that you're willing to be flexible. The LOI, for example, might include a postclosing indemnity for the seller against actions you may take after closing. In exchange, you'd want to include indemnity for yourself against actions taken by the seller while the company is still under his or her control. These might include prior environmental issues, lawsuits by employees and product defect disputes.

Finally, though LOIs are commonly nonbinding, you may wish to make some provisions binding, such as nondisclosure and confidentiality commitments. In this case, the letter should clearly distinguish between binding and nonbinding provisions.

Balancing act

Ideally, your LOI will cover both your needs and those of the seller, and provide necessary information without specifying too much. You'll have an opportunity to document the details in the purchase and sale agreement. So keep your LOI short and consider including concessions that your seller will find attractive.

Enterprise value

How smart buyers view company debt and cash

Market capitalization — a company's price per share multiplied by its total number of shares outstanding — is a common method of assessing the value of a company, particularly among investors in publicly traded stocks, whose price is set by daily trading. But some investors, including acquirers or those interested in a company's cash flow, also look at enterprise value (EV), which can be a more effective way of determining the value of both public and privately owned businesses.

Factoring in debt and cash

Market cap has been faulted because it doesn't take into account a company's long-term debt and cash, which could directly affect the stock's cash value. That's where EV can be useful. It is calculated for public companies by adding long-term debt to market cap, and then subtracting net cash and cash equivalents (or balance sheet items that can quickly be converted to cash). To calculate a private company's EV, long-term debt is added to net present value.

Adding long-term debt to the equation is particularly important when assessing companies that are heavily leveraged, because it reflects lenders' priority claims on company assets, or the true economic cost of acquiring the business. Similarly, subtracting cash offsets cash-on-hand and the funds used in the purchase because most shareholders don't have direct control over the retention or use of that cash.

Peer group comparisons

Enterprise valuation lends itself well to the relative valuation method — a process that compares a company's value against that of similar companies or peer groups. Relative valuations for private businesses commonly use ratios such as EV divided by annual sales or EV divided by earnings before interest, taxes, depreciation and amortization (EBITDA). EV comparisons are important for determining how companies of similar size, stage and industry compare in leverage and operational efficiency.

An EV/sales multiple can be useful for private businesses because sales numbers for peer companies are easier to gather than profit numbers, which most private businesses don't disclose. The EV/sales multiple also helps valuators compare the value of businesses that aren't yet profitable. Nevertheless, the EV/EBITDA multiple is more highly regarded, because a company's value is so closely linked to its profitability.

Multiples of peer companies can help you derive a private company's EV. For example, if you know that a similar company was recently acquired at an EV/sales multiple of 1.5, and the annual sales of the company you'd like to buy is $50 million, then your target company's derived EV is approximately $75 million ($50 million multiplied by 1.5).

> ***Enterprise valuation lends itself well to the relative valuation method — a process that compares a company's value against that of similar companies or peer groups.***

Of course, a derived EV isn't a substitute for comprehensive due diligence and additional valuation work, but it can be a useful initial step in the valuation process.

EV in perspective

One school of academic financial theory holds that stock markets operate efficiently because company stock prices reflect all available information over time. If, for example, a company is heavily leveraged, its market price is already appropriately discounted to reflect the debt. Investors who accept this "efficient market" approach are less likely to use the EV approach.

But for investors who believe the market isn't completely efficient because of incomplete financial disclosure by public companies and other factors, EV can be a useful method of comparing the value of companies with different capital structures. It's also important to consider because the sales prices of many deals are kept private.

Full economic value

When assessing an acquisition candidate, consider factoring in net cash and debt information. By focusing on the amount of cash you'll pocket and debt you'll owe after the sale, EV can help you understand the full economic value of your transaction.

Q. How can SWOT analysis be used to aid an M&A?

A. Commonly used for marketing and product development purposes, SWOT (strengths, weaknesses, opportunities and threats) analysis also provides a framework for owners preparing to sell their company and buyers evaluating a potential acquisition.

When marketing their company and negotiating a sale, sellers typically want to emphasize their company's strengths and opportunities. Buyers, on the other hand, are interested in strengths and opportunities, but also weaknesses and threats — particularly when they seek price flexibility. So sellers must be prepared to discuss negative factors to mitigate any devaluation on the final selling price.

SWOT information usually is assembled in a four-cell grid, with strengths and weaknesses in the top two cells and opportunities and threats in the bottom cells. This presentation makes the relationship between factors easy to assess and draw conclusions from.

Strengths and weaknesses are considered internal factors; opportunities and threats generally are considered external. Of course, factors are interrelated — an internal weakness such as a poorly trained sales or marketing department can result in an external threat such as a loss of market share to competitors.

Internal factors to consider include:

- Customer contracts and relationships,
- Brand and corporate reputation,
- Breadth and depth of products and services,
- Operating efficiency,
- Level of company debt,
- Location and condition of facilities,
- Skills of management, and
- Accounting, auditing and tax practices.

External criteria to consider include economic trends such as consumer demand, interest rates and bank-lending standards. Depending on the company and the economic cycle, any of these could be risks or opportunities. Rising interest rates, for example, pose relatively little risk for a company with heavy fixed-rate debt. But a company with the same level of debt in variable-rate securities could face sharply higher interest expenses.

Such events as the opening of new overseas markets, changes in competition due to new market entrants or exiters, or changes in customer preferences should be included in your analysis. And technology that improves production, makes possible new products, requires expensive modifications to existing products, or potentially has other effects also should be considered.

To take full advantage of SWOT analysis, think like the opposite party in your transaction. As a buyer, the better you understand your target, the more receptive the seller is likely to be to your bidding price. Sellers, on the other hand, shouldn't simply emphasize their strengths and opportunities, but also try to uncover any potential synergies and highlight them during the negotiation stage.