Merger & Acquisition Focus

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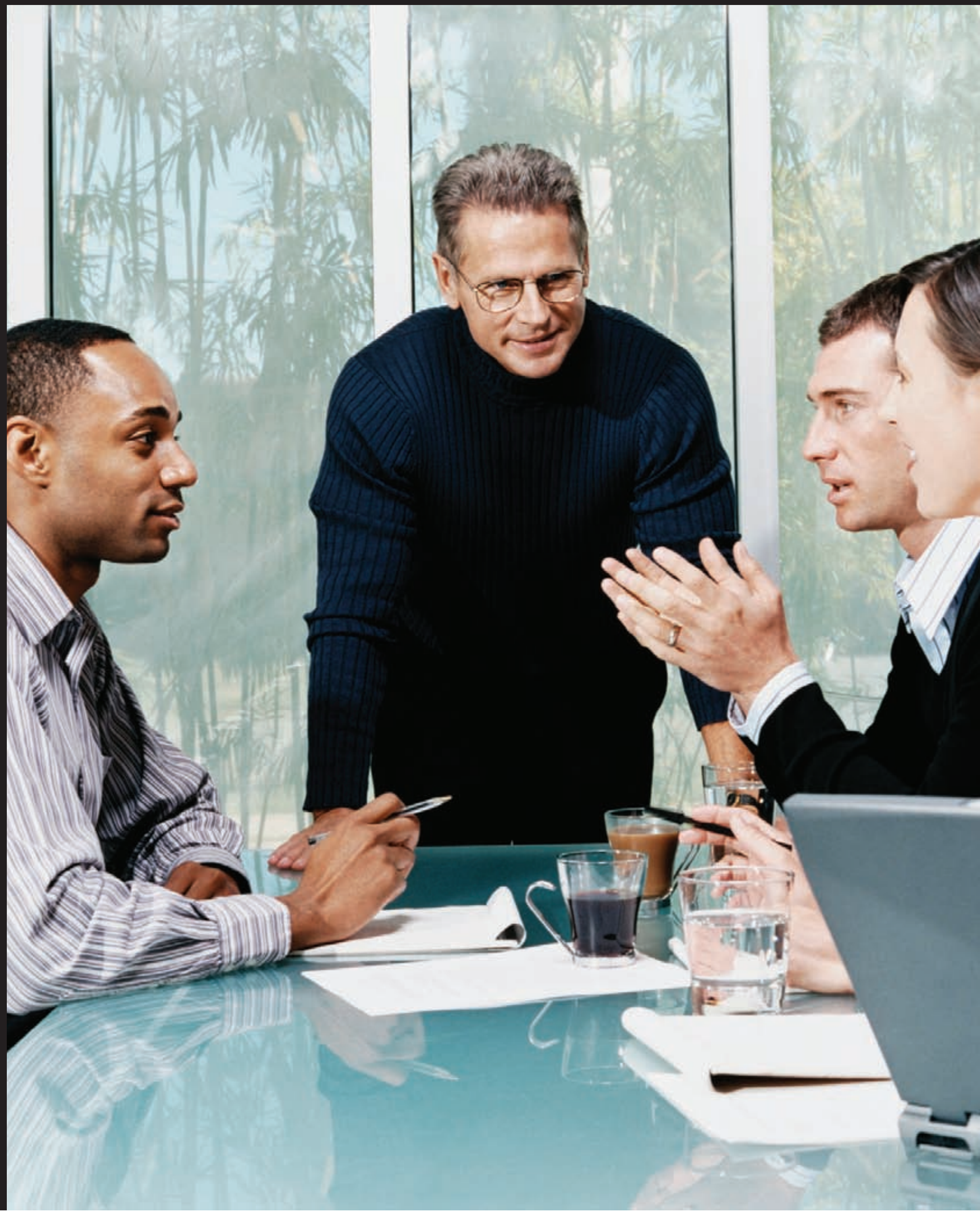
Ask the Advisor



Important questions to ask before acquiring a company

Acquisitions have the potential to offer buyers significant benefits: new products, distribution channels, technology and employees; increased market share; cost synergies; and higher sales. Yet poor planning and unrealistic expectations cause many deals to fail to generate expected financial returns. You can improve the odds your transaction will be successful by pondering several basic questions — how much, why, how, when and who — before you buy.

How much?

Overpaying is one of the hardest M&A mistakes to remedy. It's like trying to win a race with a ball chained to your leg.

Buyers can overpay for a number of reasons. Because sellers almost always know more about their company, there's an innate pricing disadvantage for buyers. In particular, buyers are more likely to overpay when they're seeking a deal in a highly competitive or hot market — especially in an auction — and when they lack the patience to negotiate methodically or are unwilling to walk if the terms don't seem right.

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To sidestep these issues, have an independent appraisal of the target company performed, thoroughly investigate the company's financials and processes during the due diligence stage, and avoid overpaying to finance the deal.

Why?

Before you buy, identify what you hope to achieve. If your objective is cost synergies, your business's operating strategies, management structure and supply chain should be well thought out. If your goal is to expand market coverage immediately, be certain you have an integration plan to combine disparate cultures across geographic regions — among both employees and customers.

Your acquisition is unlikely to be successful if your own company doesn't already have a fundamentally solid business model. Simply getting bigger through bolt-on acquisitions won't solve financial problems, particularly if you're making acquisitions in unfamiliar markets and industries. A strong company acquiring a weaker business is more likely to succeed than a weaker company buying a stronger one.

How?

You also need to understand how the organizations are going to combine *before* the deal is final. This requires you to draft a comprehensive postacquisition plan. Companies rarely integrate exactly as planned; don't fear it, prepare for it.

Know, for example, whether the two companies will be run separately or merged. Decide whether layoffs will be necessary — in either organization or both. Other questions to ask: Will part of the new firm be divested? What personnel will need to be reassigned to focus on the integration plan?

When?

Timing is essential to the success of a deal. Good timing refers not just to the point at which you approach a seller, but also to how you integrate the companies. If you expect to make widespread changes once the deal is done, begin planning for them early on.

If your postdeal pace is too slow, the financial benefits of the deal will be delayed, which could be costly or even catastrophic if you've borrowed heavily to finance the transaction. What's more, the risk of paralysis at the acquired business increases when important changes are delayed.

Know, however, that you also run the risk of acting too quickly. Due diligence, for example, shouldn't be rushed, because you could overlook fundamental problems with your target company. And hurrying fundamental changes at the new business will be disruptive if you lack adequate information and resources to manage the process.

Who?

Unlike plant and equipment, employees and customers can go elsewhere if they're unhappy, so it's important to achieve stakeholder buy-in when planning your acquisition. Morale issues are most likely to occur when communication is poor — particularly if people feel you're being dishonest or disrespectful — and lines of authority are unclear.

To avoid these problems, communicate frequently with employees about reporting changes, layoffs, benefits, restructurings, the new organization's culture and long-term plans. If you're merging the two companies, set up committees made up of employees from each organization to help facilitate change and reduce the likelihood of culture clashes.

Plan before you act

How much, why, how, when and who are only shorthand for the issues that will make a strategic acquisition a success or failure. If you're contemplating a deal, the important thing is to start your planning early and consider all potential challenges before it's final.

Who's responsible for what, when?

Your and your advisor's roles in the sale process

No one understands your company as well as you do, but many elements of a business sale require the expertise and assistance of professional M&A advisors. Which parts of the process are you responsible for and which should your advisor handle? An understanding of your respective roles can help make the transaction process more efficient.

First steps

Once you've hired an advisor, the professional will provide a general timetable of sale events. This planning exercise provides the chance to better understand what each step involves. If you have questions about what the advisor will need from you at certain stages, this is a good time to discuss it. The important thing is to start off your relationship with good communication and clearly identified roles.

After agreeing on a timeline, your advisor likely will draft a marketing plan. This document will include a profile describing your business and summarizing as much as five years of financial information. Also known as an offering memorandum, the profile will be shown to prospective buyers.

You'll likely play an active role during this stage of the sale. Your advisor can recommend the right format for your offering memorandum and most likely will be responsible for finalizing the document, but you and your accountant may provide a portion of its text and financial data.

Accounting and valuation help

Next, you will want to consider your asking price and make a list of potential buyers. While you and your advisor can compile the list together, a valuation professional should have the primary responsibility for pricing your company. Accurately valuing a company requires an in-depth understanding of finance and knowledge of what similar businesses sell for — knowledge most business owners lack.

Part of the valuation process is "normalizing" financial statements to show your company's true earning power for potential buyers. Many private business owners, for example, minimize taxable income by taking large salaries and perks such as travel and club memberships. One-time expenses and revenues, as well as extraordinary assets and liabilities on the balance sheet that may not exist under different ownership, may also need to be normalized. Your valuator will likely require your input during the process.

Marketing your business

Once a marketing plan and price are ready, it's time to begin soliciting buyers. You and your advisor each can approach prospects, though it is generally recommended that you only talk to potential buyers on your own when a close relationship already exists, and only then after nondisclosure documents have been signed.

If you want to keep your business's identity confidential, your advisor should handle prospective buyer meetings. Also keep in mind that your advisor probably is better qualified as a negotiator. Saying the wrong thing — even during the early stages of a transaction — can adversely affect the entire deal.

When prospects begin to indicate interest, you and your advisor may work together to evaluate them. The evaluation process includes the buyers' plans for financing, due diligence, closing and any other information you've requested.

Making the deal

Once you've narrowed the field, your advisor is likely to be responsible for actual deal negotiations. He or she will, however, keep you briefed as they progress. Ultimately, though, it's important to rely on your advisor's experience and negotiating skills to get the best price and conditions.

These skills also will be useful after the winning bidder completes due diligence and the purchase and sales agreement is hammered out. This step, which is the last before the actual deal is signed, usually involves additional negotiations over the contract's conditions, contingencies, warranties and other details. Owner involvement at this stage potentially could hinder the process because owners are usually emotionally invested in their business.

When possible, delegate

To make your partnership with your advisor effective, approach the process with flexibility and an open mind. Your advisor is more likely to make suggestions that ultimately get you the best price and conditions. Also be honest about needs and goals, so your advisor understands what's most important to you.

Finally, and perhaps most critical, be prepared to delegate those parts of the process that require the M&A knowledge and experience you probably lack. After all, you have other things that require your attention — including running your business.

Valuing a business for gift, estate, and other tax purposes

The IRS guidelines for valuing closely held businesses, whether for gift or estate tax or M&A purposes, don't require a particular method. But according to IRS Revenue Ruling 59-60, eight factors should be considered when valuing shares in private companies. The original ruling and its modifications have set the gold standard for valuing business interests.

> *The ruling recognizes that a controlling interest in a business should be valued at a premium, as opposed to minority blocks of stock.*

The value of a business affects the tax-related costs of selling, gifting or bequeathing business interests. The complexity of creating a valuation that will pass IRS muster means a professional valuator is required. Accreditations in business valuation provide much greater protection in arbitration if a valuation is ever disputed.

8 factors

The eight factors were set forth in Ruling 59-60, which applied to closely held corporations for gift and estate tax purposes, and is a commonly used valuation method for M&As. A separate ruling later extended the factors to valuations of partnerships, limited partnerships and proprietorships. The factors are:

1. Nature and history of the business. This takes into account the type of business, including its products and services, operating and investment assets, capital structure, plant facilities, sales records, and management. The valuation also must consider the company's stability, growth and diversity of operations. Recent events should be weighted more heavily than distant or nonrecurring events.

2. Economic conditions. Current and future economic factors should be considered insofar as they do or may affect the business and its competitors. The possible loss of a key manager — particularly in a one-person business — should also be taken into consideration, as should offsetting factors such as the existence of a key person life insurance policy.

3. Balance sheets. A business's balance sheets from the past two years, including supporting schedules for complex assets or liabilities, are important considerations. If the business has different classes of stock, the rights and obligations of each class should be reviewed.

4. Income statements. Income statements from the past five years should be reviewed. The statements should include sufficient detail so that nonrecurring items are identified and the statements can be reconciled with corresponding balance sheets.

5. Dividend-paying capacity. The valuation should consider the company's dividend-paying capacity over

the narrower category of dividends actually paid. This is because controlling shareholders may substitute salaries and bonuses for dividends, which can understate the business's actual dividend-paying capacity and, thus, its value.

6. Goodwill. While the ruling acknowledges that goodwill and other intangibles may be hard to value precisely, it cites a company's prestige, brands and record of long-term operating success as possible contributors to its value as an entity. A detailed comparative analysis of other related market intangibles and of business stature without the intangible items identifies benchmarks for goodwill value.

7. Previous stock sales. When considering earlier sales of company stock, valuators must apply their judgment.

Putting a price on restricted shares

Agreements restricting the transfer of shares are common in closely held businesses. Such agreements can affect the value of shares by mandating a specific price or limiting the purchase to specific people.

IRS Revenue Ruling 59-60 covers the valuation of these types of shares, stating that, when a buyout agreement fixes the value of shares at the death of a shareholder, the price can be considered a fair market value for estate tax purposes. In contrast, buyout agreements that allow voluntary transfers by living shareholders may not result in fair market value for estate or gift tax purposes.

The ruling's intent is to prevent assets from being transferred at what it calls "less than adequate and full consideration in money or money's worth," and to promote "a bonafide business arrangement" at fair market value. Business owners considering making a gift or bequest of restricted shares should, therefore, consult their legal and tax advisors to make sure they understand the likely tax consequences of the transfer.

For example, a distressed transaction or the sale of small percentages of shares isn't necessarily indicative of fair market value. The ruling also recognizes that a controlling interest in a business should be valued at a premium, as opposed to minority blocks of stock, which are more difficult to sell.

8. Stock sales of similar companies. Considering sales of stock in publicly traded companies is appropriate. But care must be taken to ensure that only comparable companies are considered. Public companies in similar lines of business but with different classes of stock, levels of indebtedness, asset sizes, locations, numbers of employees, growth rates or profitability shouldn't be considered directly comparable.

Weighting the factors

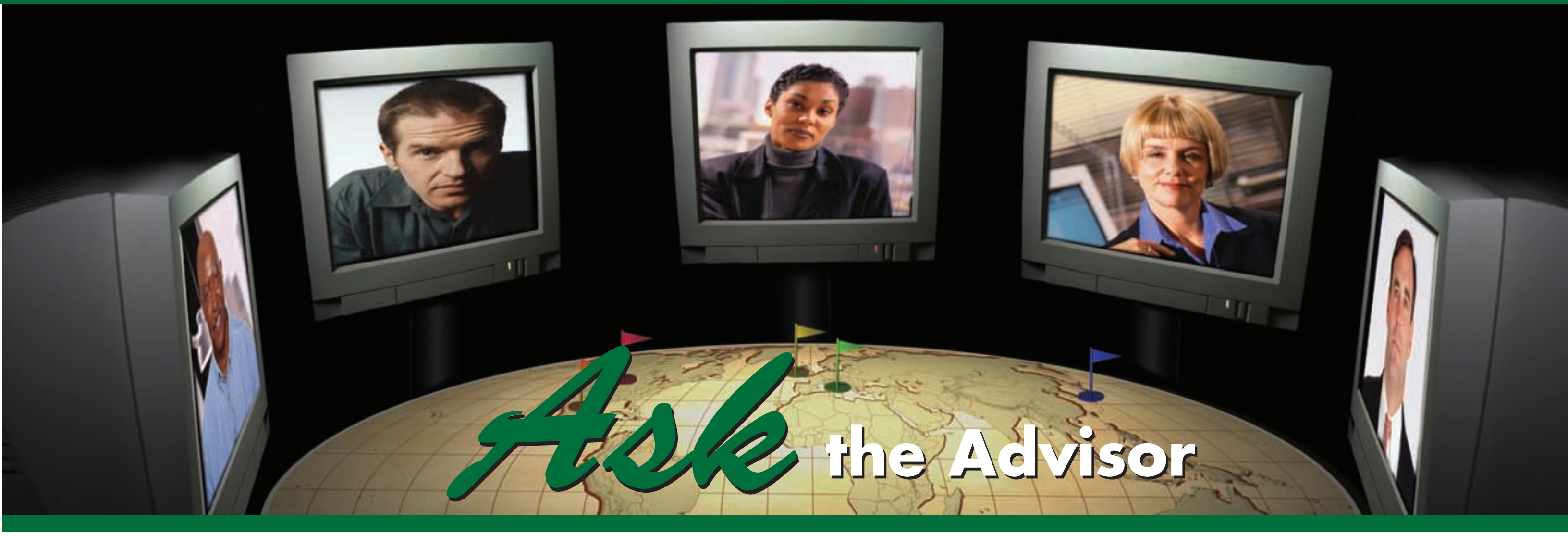
While Ruling 59-60 requires that all eight factors be considered, it also acknowledges that some factors may be more important than others, depending on the company being valued. Earnings, for example, may be the most important factor for companies that sell products or services, while asset values may be the primary consideration when valuing investment firms or real estate holding companies. As a rule, valuation techniques multiply a company's earnings by a "capitalization rate," or the return on investment an investor could expect for assuming the risk of the investment.

Ruling 59-60 also discourages simply averaging several valuations — such as book value, capitalized earnings and capitalized dividends — to derive a final value for a business. The ruling doesn't provide a standard capitalization rate for analyzing earnings or dividends. Instead it notes that, when capitalization rates are used, they should be based on the nature of the business, risk involved, and stability or irregularity of earnings.

The ruling in perspective

The theory and practice of valuing businesses have evolved significantly since 1959 when the ruling was issued, but its eight elements are still relevant. In fact, this ruling is widely accepted even in non-tax-related valuations and has been frequently cited by civil and family courts.

Because its breadth, clarity, flexibility and reliance on good judgment make it an excellent conceptual framework and useful checklist, a valuation professional is likely to apply it when valuing your business.



Q. Why should I consider an earn-out provision?

A. An earn-out provision is language in a purchase and sale agreement that commits the buyer to make payments to the seller if the business achieves agreed-upon financial targets following the sale. Earn-outs also may be referred to as payouts or contingent payments.

Earn-outs are often useful when buyers and sellers can't agree on a price or when the transaction is only possible if the seller finances a portion of the purchase price. The seller may believe the business has good financial prospects and merits a higher sale price, but the buyer is unwilling, or unable, to pay it.

To break the deadlock, the seller agrees to accept a lower payment at closing with a held interest and the promise of additional remuneration if the business meets certain financial milestones. The seller releases held interests as these remunerations are paid and may maintain rights to assets of the company if the buyer fails to meet a specified schedule.

Earn-out provisions have several components. A quantitative formula typically determines how much is to be paid if a financial target is reached. For example, a buyer might agree to pay the seller 20% of annual earnings that exceed the prior year's earnings by a certain amount. A target also might be based on annual cash flow, sales or other metrics. A payout provision also specifies when and how many payments are to be made.

The term covered by the earn-out provision generally runs no longer than three years. Longer periods can subject the seller to additional risk, because they increase the possibility of adverse business events beyond the seller's control. So if a longer period is envisaged, sellers should consider financing in the form of a loan or preferred stock in the company — both of which offer remedies in the event the business is mismanaged and the buyer can't meet financial obligations.

Earn-out provisions also address contingencies that could affect the business's ability to reach agreed-upon milestones. Say, for example, an acquired company must achieve certain levels of earnings. After the sale, the new owner decides to write down the value of a large asset or invest in expensive new equipment that boosts depreciation expenses. The resulting changes could significantly lower earnings, and the seller could lose out on one or more earn-out payments.

Such developments aren't uncommon, so earn-out provisions should state how contingencies are allowed to affect payouts. Should accounting changes be allowed to reduce payouts? Should large capital investments be allowed to distort expenses? The seller may require regular open-book access to accounting reports and other proof of financial operability to ensure accurate earn-outs.

Acts of God, the receipt of insurance proceeds, the early sale of the business and arbitration procedures in case of disputes are other details to address. Finally, to avoid future disagreements, both parties should specify how each contingency will affect earn-outs.

Earn-out provisions are useful tools for helping buyers and sellers that are having trouble bridging a price gap. But because a comprehensive provision is better than one that leaves many contingencies unaccounted for, both parties should have experienced legal counsel draft the agreement and be involved in the negotiation process.