

THE

# M&A

ADVANTAGE

Spring 2009

## Preparing to sell in an uncertain market

How you can attract private equity investors

Make the case

*Writing a compelling company profile*

Tax advantage

*Section 338(h)(10) can help S corp buyers and sellers*



# Preparing to sell in an uncertain market

**A**lthough the U.S. economy is in critical condition, you shouldn't approach selling your business as you would a funeral. An M&A deal can succeed — even in the current environment — if you start preparing as early as possible. Effective preparation entails streamlining and shoring up your company's operations and financials, and may require you to make some difficult, but necessary, decisions.

## CLEAN UP THE BOOKS

One of the first actions a prospective seller needs to take is to ensure the company's financials are accurate and easy for potential buyers to examine. Make sure all your revenues are detailed and correct and are broken down logically, by, for example, business unit. Try to remove as much personal-related expenses, such as club memberships or vehicle fuel costs, as possible from your company's financials.

If your company doesn't already use the accrual basis of accounting, you may want to switch to it. Prospective buyers are likely to prefer businesses that use accrual-based, as opposed to cash-based,

accounting because it's usually the method they use. Cash-based accounting isn't typically considered "a true and fair view" of a company's financial performance under International Financial Reporting Standards — standards public companies soon will be required to adopt.

## PERFORM HOUSEKEEPING DUTIES

Preparing for sale should give you the opportunity to perform long-needed tasks you might have put off because they never seemed as urgent as other, day-to-day matters. But tackling housekeeping is important now. Trimming and streamlining operations across your organization — from human resources to outstanding debts to supplier relationships — will help make your company more attractive to prospective buyers.

*If you can renegotiate or prepay current debts, you'll probably improve your company's marketability.*

Perform a comprehensive review of your operations, pinpointing weaknesses and redundancies, and then draft an action plan to address potentially negative findings. If, for example, you discover outmoded equipment you can no longer use, you should probably sell it. Or, if you find multiple employees doing a job that only requires one person, consider reassigning or terminating the extra employee.

Also examine your company's current debts and compile a list of obligations that are due in the near term as well as the ones that carry the most onerous terms. Potential buyers will regard such debts as unattractive — especially in today's poor credit environment. So if there's any way you can renegotiate or prepay them, you'll probably improve your company's marketability.



**"So I told Tom to sell the business or I was moving to Florida without him. I haven't seen him since!"**

As you streamline, keep your potential buyer's perspective in mind. This can be difficult if you haven't already identified a specific buyer, but some qualities — such as effective inventory management — will be important to most acquiring companies (see sidebar, "Managing inventory: FIFO or LIFO?").

### DON'T NEGLECT TOUGH CALLS

As soon as you make the decision to sell, your company needs to review, and possibly revise, its relationships with external stakeholders. Start with current supplier contracts, deciding which relationships are most critical to the success of your day-to-day business and which ones might have outlasted their usefulness. Also, if you've had difficulty or experienced conflict with any suppliers, now's the time to consider cutting ties.

Look at your customer or client relationships as well and ask if:

- You're too reliant on one or only a few customers,
- Your customers tend to be clustered in one city or geographic region, or
- You're overexposed to certain sectors, particularly those — like real estate, construction and manufacturing — that are more vulnerable to the downsides of macroeconomic cycles.

Most business buyers prefer targets with well-diversified customer bases because diversification generally reduces the risk that a business will suffer insurmountable losses if it loses one customer or if a particular region or sector declines.

It's also never too soon to consider the effectiveness of your employees. Determine which ones are essential — particularly at the upper management level — and make efforts to retain them with incentives such as bonuses or greater responsibility. If staff reductions and unit consolidations are needed, try to conduct layoffs before putting your business on the market. Eliminating redundant staff will cut your overhead expenses and improve your financials as well as save the company's eventual buyer the trouble of making those cuts.

### Managing inventory: FIFO or LIFO?

When it comes to managing inventory, companies have two choices — FIFO (a "first-in, first-out" accounting system that records older inventory items as sold first) or LIFO ("last-in, first-out," which does the opposite of FIFO). Choosing one or the other can be a major decision that affects your company's income statements and eventual sale price — particularly in a higher-inflation environment.

**FIFO** generally makes sense for companies whose goods have high expiration rates, such as food, or whose goods may lose their potency or effectiveness, as in the case of pharmaceuticals and chemicals. Using FIFO generally results in higher income, because it recognizes "inventory profits" — profits derived from inflationary price increases while inventory is being stored. And under FIFO, a company's balance sheet likely will show a higher value for the inventory at hand.

**LIFO** is a better fit for companies without expiration-related issues. Assuming that inventory prices rise as a result of inflation, LIFO records the most expensive inventory (the most recent arrivals) as being sold first. This method reduces overall profits and the value of inventory at hand on a company's balance sheet.

LIFO accounting can reduce tax exposures on income. And it's often a more accurate method of matching current product costs against current revenue, which is likely to appeal to prospective buyers.

### NEVER TOO EARLY

In the current volatile economy, a lean and healthy company is more highly valued than ever. With the help of your M&A advisors, do everything you can to shape up your organization, and you'll be better prepared to make a compelling case to buyers. □



# How you can attract private equity investors

**A**t a time when publicly owned companies are finding it extremely difficult to access the capital they need to make acquisitions, private equity groups (PEGs) can still be an option for some business sellers. PEGs tend to be less constricted because they're not as reliant on the credit markets, and many are looking to put their ample funds to work.

Attracting the attention of these investors, however, requires some understanding of how they work and what they look for in an acquisition target.

## BACK IN THE GAME?

PEGs typically are funded by third-party investors, including individuals and institutions. They make

money for their shareholders by acquiring companies, and then "flipping" them after a holding period of several years. PEGs either sell their holdings to new buyers or initiate a public offering, ideally realizing gains.

*In a recessionary economy, positive cash flows and competitive market shares are more advantageous than ever.*

For much of the past decade, PEGs have been major players in the M&A market, their aggressive acquisition tactics spurring global M&A volume.

As has been the case with the entire financial sector, the global economic slowdown has sidelined many PEGs over the past year.

Although some of these investors seem to have retreated for the foreseeable future, others appear to be waiting for an opportune moment to get back into the M&A market. PEGs have continued to raise new capital, and some appear to be stockpiling their balance sheets in anticipation of a future buying boom.

Private equity firm Audax Group, for example, recently announced that it would buy debt-collecting business URS. And Kelly Capital LLC, a San Diego-based PEG, agreed to purchase automotive paint and collision repair company Earl Scheib Inc. for \$8 million — roughly \$2 per share.

## APPEALING QUALITIES

These recent PEG acquisitions highlight the characteristics of companies that



are successfully selling these days. In a recessionary economy, positive cash flows and competitive market shares are more advantageous than ever. And companies in relatively insulated and low-risk business sectors, such as accounting and debt collecting, also have an advantage.

Whatever your industry, several factors can boost your company's appeal — in both rough and rosy M&A markets. They include:

**Highly capable management.** Many PEGs aren't interested in immediately replacing their acquisition's management team, unless, of course, the company is financially distressed or organizationally troubled. PEGs, therefore, look for companies with skilled and seasoned management made up of individuals looking to transition out of the business eventually.

**Low debt.** PEGs typically fund acquisitions with a combination of equity capital and large amounts of leveraged debt — intending for the acquisition's future cash flows to repay that debt. If your company has a relatively low debt burden that a PEG could add to its balance sheet, you have a big market advantage — particularly in a credit crunch.

**Aggressive growth plans.** Because PEGs plan to sell their acquisitions after a period of several years — or, once the company achieves hoped-for returns — these investors tend to prefer higher-growth businesses. You're in a good position if you have strong future earnings projections, a rapidly growing customer base and an increasing market share.

## MEET THE PLAYERS

As is true in much of the business world, it's not just who you are, but whom you know. The PEG world is no exception and is built heavily on personal relationships. In fact, many PEGs staff their advisory boards with former executives of their past acquisitions who, in turn, advise the PEGs on future purchases.

## Smart shopping: PEGs and retailers

As the financial woes of major U.S. retailers — including stores as disparate as Circuit City, Sears, Office Depot and Linens 'n Things — attest, moving merchandise is extremely challenging in the current economic environment. Depressed company values in the sector, however, are piquing the interest of some private equity groups (PEGs).

PEGs may be attracted to retail, according to a recent CNNMoney.com report, because these businesses tend to generate cash and often own real estate that can be sold. And although Americans have cut back on their spending in the last year, consumers still need to buy essential goods. PEGs, therefore, are likely to look for fundamentally sound companies in good markets and offering core products that could benefit from restructuring.



Access to private equity investors is one of many good reasons to work with an M&A advisor when selling your company. An experienced advisor will already know the private equity market and its major players, including board members.

Your advisor also will know which PEGs specialize in your industry or type of business and will have some idea of the company characteristics favored by particular PEGs. This will help you market your company to their criteria and increase the likelihood that you'll receive a lucrative bid.

## EXPLORE YOUR OPTIONS

Corporate acquisitions have slowed significantly as credit has dried up, and these buyers are likely to stay out of the M&A market for a while. PEGs, however, may still be an appealing option if you're ready to sell now. Many PEGs have retained their appetite for acquisitions and, more important, have actual money to invest. Private equity may not be the solution for every seller, but you should discuss this option with your advisors. □

# Make the case

## Writing a compelling company profile

**B**usiness buyers typically have many acquisition choices and only limited time to investigate each prospect. Your company profile often is the first impression potential buyers get of your business, so it must grab their attention. By writing a concise, on-point profile that focuses on your company's best qualities, you can build a compelling case for its purchase, and even increase bid amounts.

### SPEAK WITH ONE VOICE

Once they begin the search for an acquisition target, buyers are likely to have dozens of company profiles cross their desk. So the question is, what actions can you take to ensure that yours stands out?

Although you probably will solicit information and opinions from many different managers in your organization, your profile needs to have a unified voice. A profile that's obviously the product of dozens of contributors — each trying to boost his or her own unit — can make for an unappealing, and confusing, read. Instead, choose only one or a few writers to compile relevant information and write the profile.

A single voice will help ensure that your profile's balanced, but also that it highlights items of greatest interest to prospective buyers. It's also more likely to provide a clear and compelling argument about your company's value.

### USE SPACE WISELY

Company profiles can contain all kinds of information, depending on a company's industry, specific characteristics and the M&A marketplace. But all profiles should feature:



**The basics.** Essential background information includes how long your company's been in business, its ownership history and business structure, products or services base and market share.

**Financial highlights.** Include anywhere from three to five years' worth of financial information that has been distilled to its basics — revenues, assets and debts.

**Corporate leadership breakdown.** Provide names and brief bios of your key executives, including all of the heads of departments and units, board members and your CEO.

Also leave room for your client or customer list, and an inventory of furniture, fixtures and equipment (FFE) to be included in the sale.

### MAKE A PROPOSITION

Perhaps the most important text your profile can include is what is generally known as a "unique selling proposition." Depending on your business, this proposition might be a greater market share, trimmer work force, better product lineup or more valuable customers. Your profile needs to accomplish what the most successful brand advertising campaigns have — selling your audience on the unique value of your company.

Make the case with a clear statement saying that your company does something better than your competition. If you're not quite sure what that superior quality is, ask your M&A advisor to review your company's strengths and distill them into an essential pitch.

Make sure your pitch isn't dry, either. Impart some sense of your company's business culture — what makes it vibrant and capable of growth — by providing details about day-to-day work in your office or production facility and, if your company's involved in community support or has other interesting sponsorships, your external commitments.

### WHY, WHAT AND HOW

Now isn't the time to go it alone. An effective company profile requires the input and feedback of seasoned M&A advisors. Your advisors can help you craft a profile that's not only easy to read but, more important, sums up your company's core values and how its acquisition would be advantageous. □

# Tax advantage

## Section 338(h)(10) can help S corp buyers and sellers

**I**f you're planning to sell a business arranged as a subchapter S corporation, a provision of the federal tax code can make you a more appealing target for buyers. Even better, it could boost your sale price.

### WHY BUYERS LIKE THE CODE

S corporations don't pay income taxes. Instead, the company's income or losses are distributed through its shareholders, who in turn report income or losses on their individual income tax returns. This fact can potentially complicate the sale of an S corporation.

Internal Revenue Code Section 338(h)(10), however, enables a stock sale of an S corporation to be taxed as if the transaction were an asset sale. Asset sales offer several advantages. For one, the buyer can take a "stepped-up" tax basis, which means it can significantly raise the stated value of the seller's assets. Greater asset value, in turn, enables a buyer to claim more depreciation on its to-be-acquired assets and, therefore, take a larger, current tax deduction.

### WHAT'S IN IT FOR SELLERS

This advantageous tax situation puts selling S corporations in an excellent negotiating position. Buyers must obtain the approval of the selling company's shareholders to structure a deal that includes a 338(h)(10) election. And buyers typically are willing to agree to a higher purchase price in exchange for shareholder cooperation.

In a 2005 study analyzing S corporations, Merle Erickson, an accounting professor at the University of Chicago's Booth School of Business, and Shiing-wu Wang, a professor at the University of Southern California's Marshall School of Business, estimated that the tax benefits of S corporation acquisitions total, on average, approximately 12% to 17% of the deal's value.

For example, when Coca-Cola Enterprises acquired the S corporation Herb Coca-Cola Inc. in 2001, it



paid Herb's shareholders an extra \$100 million to approve the 338(h)(10) election. Coca-Cola reportedly valued the tax benefits of the election at \$145 million, thus paying Herb shareholders 70% of the total tax benefits.

Despite these kinds of benefits, many S corporation sellers are unaware of or ill-informed about the tax code provision. Unfortunately, sometimes buyers use seller ignorance to take the deduction without offering a higher acquisition price in return.

### KNOW YOUR ADVANTAGE

Realizing the tax advantages of Section 338(h)(10) is a complex process. So it's essential to work with experienced advisors who are knowledgeable about tax issues. They can help you determine if your business is eligible and ensure you get an equitable share of any tax benefits a buyer derives from the acquisition. □