

THE M&A ADVANTAGE

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Hard times?

Now may actually be a good time to sell a business

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Hard times?

Now may actually be a good time to sell a business

Given the state of the financial markets and general economy, now may seem like an unlikely time to sell a company. But selling in the current market can actually be less challenging than you think — and may even provide benefits you haven't considered.

Determining whether to sell is always a difficult and complex decision, involving many considerations specific to your plans and business. For example, how urgent is your exit plan and how much do you hope to realize from the sale? Although the current economic environment may factor into your decision, it shouldn't be your primary consideration.

BAD NEWS, GOOD NEWS

To sell your company at a fair price, you need only one buyer that really wants to acquire it. A global credit crunch means that some buyers have limited financing options right now and may not be looking for targets. That's the bad news. The good news is that many of the buyers shut out of the current market are financial buyers — companies seeking opportunistic, short-term investments — such as private equity and hedge funds. The majority of those remaining are strategic buyers seeking synergies and other long-term advantages of an acquisition.

As long as your company doesn't have significant liabilities that may necessitate compromise, remain confident.

These buyers may be willing to pay more for a target that meets their specific needs. What's more, companies that are profitable and not highly leveraged are regarded as attractive acquisition targets regardless of market conditions. Stable earnings and low risk are particularly prized in poor economies, and private companies immune to day-to-day stock fluctuations enjoy an additional advantage.



Owners of larger companies might want to explore whether selling their business in pieces — by division, subsidiary or asset — rather than as a whole is a favorable option. Partial acquisitions can be attractive to buyers who want a specific product line, hard asset such as a production facility or human resources such as a software development group.

SHAPING UP

As long as your company isn't financially distressed and doesn't have significant liabilities that may necessitate compromise, you should remain confident in its appraised value. Several strategies, however, can help improve your chances of selling well.

Reducing short-term debt, if at all possible, is near the top of that list. If you have outstanding loans or upcoming loan or bond financings, ensure that you're current on payments. Few buyers will be interested in assuming additional debt from a

prospective acquisition — particularly debt with onerous rates and terms.

A current business valuation that takes into account your company's long-term performance is also essential. Buyers may try to get a reduced deal price by arguing that any recent performance declines due to a poor economy make your business a less viable acquisition. So you need to be prepared to show that historical earnings are solid and explain to buyers that they provide a better forecast for future performance. (See "Putting a price on your business," page 6.)

OPPORTUNITIES REMAIN

If you put your company on the market only to encounter unappealing bids or even deafening silence, your effort isn't in vain. Entertaining offers helps you understand what buyers are looking for. What's more, displaying your strengths can put you on the radar of buyers that are financially constrained now but plan to make acquisitions once conditions improve.

With the assistance of experienced M&A advisors, you are very likely to find a fair price for your business. Good companies are always valuable — even in hard times. □

Turning to earnouts

A potential solution for negotiation stalemates

Sometimes merger and acquisition negotiations reach an impasse — even when both parties are committed to making the deal succeed. When buyers and sellers are at loggerheads over pricing, all of the transaction's benefits can fall to the wayside.

There may, however, be an alternative: an earnout. With an earnout agreement, the seller might remain with the company to operate it after it has been sold. The buyer agrees to make periodic payments to the seller if the company meets specific performance goals.

INCENTIVES FOR EVERYONE

An earnout can be a particularly effective way to bridge the gap when the buyer and seller disagree about the value of the company. The promise of future payments can assuage seller concerns that they're settling for a price that undervalues their business. And, assuming the seller remains in control of operations after the sale, earnouts help reassure the buyer that the seller will work hard to maintain the company's performance.

Keep in mind that earnouts are far more effective for sellers when, postmerger, the selling company continues to operate as a stand-alone subsidiary or the seller continues to manage it as a division of the acquiring company. If a target is intended to be immediately absorbed by the buyer, earnouts may not make sense. Sellers will have little control over the newly merged company's performance.

NEGOTIATING THE DETAILS

Although earnouts often provide a solution to difficult price negotiations, the process of agreeing on an earnout structure can prove challenging as well.

The parties need to discuss the form that seller payments will take as early as possible, because this decision can have other ramifications.

If, for example, a seller wants to be paid in stock, the parties must decide whether the stock will be valued as of the deal closing date, at some other date or by another measure.

The parties also must agree on the objectives that must be reached to trigger earnout payments and an acceptable accounting method (typically, Generally Accepted



Accounting Principles) by which to measure achievement of these objectives.

Earnout objectives could include:

Sales. Often, sellers prefer that performance be measured by gross sales, because they provide a clear goal that management can directly influence.

EBITDA. If performance is measured by EBITDA (earnings before interest, taxes, depreciation and

amortization), the seller will need to show that it's achieving a certain level of pretax cash flow. Earnout payments typically are a percentage or multiple of the amount by which the seller division's results exceed a set EBITDA figure.

Annual performance. The parties may agree to set an annual performance threshold based on revenues.

Nonfinancial. In some earnouts, payments are based on nonfinancial goals specific to the industry or business. A manufacturer, for example, may be required to successfully roll out a new product that is only in the development stage. Or a pharmaceutical company may need to obtain FDA approval to market a new drug.

When the seller needs to pitch in

If deal negotiations are breaking down because a prospective buyer is unable to secure adequate financing, you might consider seller financing. Not only does it get the deal going again, but it reassures buyers that sellers have faith in the company's future.

Seller financing can be accomplished in one of two ways:

1. Sellers purchase debt or stock from the newly merged company — in effect lending money to the buyer to acquire the seller's business.
2. Sellers agree to accept retroactive payments from the buyer. Typically in this scenario, the buyer makes a down payment, giving the seller a promissory note carrying interest for the balance. Notes usually cover between 25% to 50% of the overall purchase price.

This second strategy is particularly popular when a selling company is a little larger than businesses considered purchasable for cash, but smaller than those that typically attract deep-pocketed buyers. Retroactive payments are also often used when the seller's business is unusual or greatly affected by seasonal or market conditions.



DON'T FORGET EXEMPTIONS

Sellers typically request protections to ensure earnout payments regardless of the buyer's financial condition at the time they are due. Buyers, on the other hand, generally try to include language in the agreement that subordinates earnout payments to other obligations, such as outstanding loans.

Sometimes circumstances make it difficult for sellers to meet earnout goals. For sellers, therefore, it's crucial to negotiate earnout exemptions. Sellers generally push for a widespread set of exemptions to ensure that, for example, future capital expenditures or the introduction of competing product lines doesn't erode their ability to achieve earnout goals.

For their part, buyers usually try to ensure the selling company's owners and executives don't maximize short-term goals at the cost of long-term profitability. For example, a seller might focus on selling large volumes of existing products while neglecting new product development.

But parties can bridge such differences in interests. A buyer might retain the right to take actions that could affect the seller division's sales or profits, but the financial impact of those actions will be excluded from the seller's earnout calculations.

DIFFICULT BUT FAIR

Failure to agree on price is one of the most common M&A deal-breakers. Earnouts can introduce flexibility to a negotiation stalemate. The key to success is to ensure that both parties walk away from the table feeling they have achieved their most important goals. □

How to hold on to key employees

During a company merger, the devil is in the details. Identifying key employees and employment issues early on can facilitate a smooth deal. And a communication plan can help prevent, for example, top-producing salespeople from defecting to competitors, decimating the company's customer base, and affecting its value.

It's important to offer employees incentives to stay, but you also need to anticipate potential legal issues. Plan now to put in place protections to prevent employees from disrupting your deal, both before and after it closes.

RESEARCH TO RETAIN

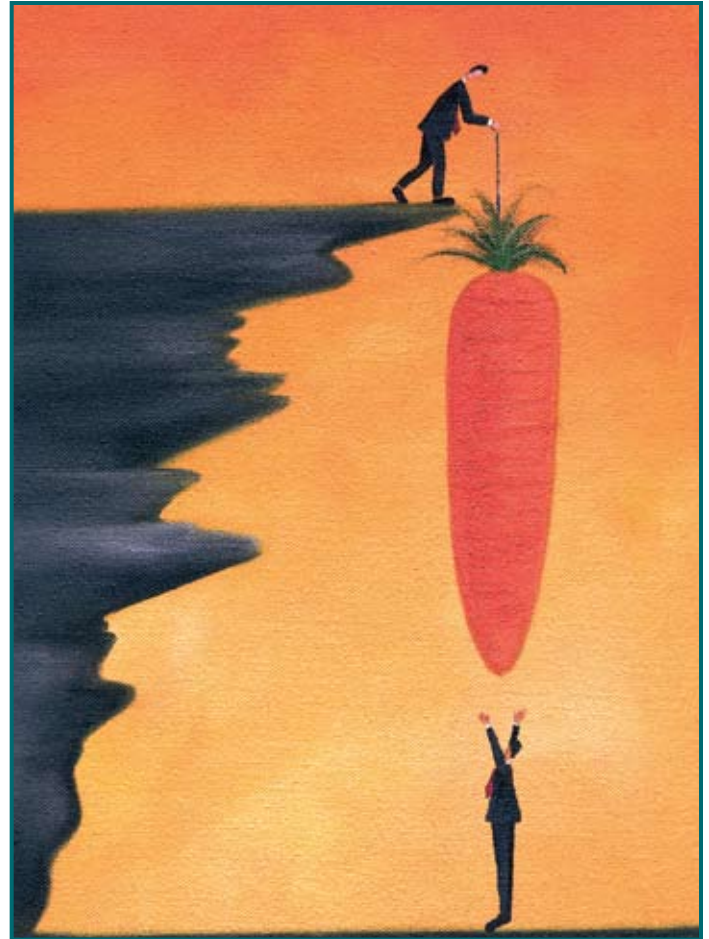
As soon as you begin entertaining the idea of a merger or acquisition, assess your current workforce. Enlisting the help of your human resources staff, interview managers and ask them to break down employee responsibilities and identify the top performers in each department. If units are to remain productive after the company changes hands, you must know which employees are responsible for the most — or most important — customer or client relationships.

Employee incentives could include anything from stock options to a guaranteed executive position.

If your company's value relies heavily on research and development or intellectual property, be sure you know who the key brains are behind your brain trust. Without those individuals, your business may have much less future earnings potential and be a lot less attractive to a buyer. And though the topic is broad and beyond this article's scope, begin reviewing patents and other intellectual property to ensure you, not your employees, own them.

THE CARROT AND THE STICK

Once you or the buyer determines which employees are essential, provide them with incentives to stay



put. Depending on the nature of the business, the employee and the terms of the deal, this could be anything from stock options in the newly merged company to a guaranteed executive position to extra vacation time.

Don't stop with the carrot, though — you also need to introduce the stick. Draft agreements that will prevent employees from walking away with the cream of the company's staff or the most profitable customers. If they haven't already, top performers should sign noncompete agreements that prohibit them from directly competing against the company for a specific period of time.

Watch out for a common loophole, though. In some cases, employees will have noncompete agreements with their original employer (the selling business) that aren't applicable to the newly merged company. If necessary, ask employees to sign new agreements.

Also keep in mind that noncompete agreements aren't enforceable in some states, such as California, and under certain conditions, such as when agreements interfere with the employee's ability to earn a living. Agreements that are unreasonable as to time, distance or purpose can also be deemed unenforceable, so discuss noncompete agreements with your legal advisors before asking employees to sign them.

OUT IN THE COLD

Next, assess whether your company has any employee-related legal exposure. Do you have reason to believe (for example, based on past disciplinary actions) that a manager will be sued for discrimination or other illegal on-the-job actions? Are you currently engaged in litigation with one of your employees over workers' compensation benefits?

Potential buyers need to know about such situations because their outcomes can seriously affect future profitability.

PEOPLE MATTER

The secret to managing employee issues during a merger is to be proactive. Determine which employees are critical and make sure paperwork is in place to keep them. Also communicate your merger plans to the larger company as soon as feasible and keep tabs on employee morale as the deal closing approaches.

Although all M&As encounter an unexpected obstacle or two along the way, employees don't need to be one of them. □

Putting a price on your business

If you hope to attract buyers that will make fair bids for your company, you first need to have a good understanding of its value. M&A advisors and professional appraisers can provide you with information that will help you with everything from setting a reasonable fair market value price to advantageously negotiating your deal's final terms.

EXPERT OPINIONS

Many business owners hire a professional appraiser at some point — for example, when drafting a buy-sell agreement or making estate plans — to review their company's books and operations and provide a ballpark estimate of its value. An appraiser's services can also be useful when you're ready to sell your business.

One of this professional's critical tasks is to normalize earnings — that is, to adjust them to better reflect your company's performance under different ownership. The appraiser might make adjustments to earnings for one-time expenses, such as tax penalties or legal costs. And adjustments generally are made for discretionary expenses such as inflated (or artificially low) salaries and bonuses, and



"Let's see . . . A first class cruise around the world for one year for two people. That means your business is worth \$680,000."

nonessential items such as club dues or company-owned vehicles.

An appraiser will also consider your accounting method. Many private businesses use a cash basis

accounting system, which can accelerate expenses such as depreciation, ignore expenses like debt and defer revenues such as completed contracts for more favorable tax treatment.

Your company probably will look more attractive to buyers, however, if income and expenses are converted to an accrual basis, which records these items in the period they're earned or incurred.

In weaker economies, an appraiser might project your company's future earnings under more favorable economic conditions, based on your historical numbers. These projected earnings can be particularly useful when sale negotiations get sticky and you need evidence for your price position.

PRICING FOR THE MARKET

Although a professional appraisal can give you a general idea of your company's worth and make your financials appear in their best light, you also need M&A advisors to help you set a reasonable market price. Ultimately, your company's value is the price a buyer is willing to pay — regardless of the number you have on paper.

Companies with powerful value drivers such as proprietary technologies, critical patents or market-leading brands may merit a higher price than standard multiples suggest.

In setting a price, M&A advisors might consider variables such as the current economic environment, the M&A marketplace, conditions in your industry and recent sales prices of businesses comparable in size, history, current cash flows and future earnings projections, among other characteristics.

That information might be used to set a price based on your company's earnings before interest, taxes, depreciation and amortization (EBITDA), with three to six times EBITDA at the low end and seven to 10 times EBITDA in the higher range.

Companies with powerful value drivers such as proprietary technologies, critical patents or market-leading brands may merit a higher price than standard



multiples suggest. And if you or your M&A advisors already have a potential buyer in mind, your initial price will likely reflect what that buyer considers your company to be worth. A competitor, for example, may be willing to pay an above-market price to eliminate you as a threat and gain access to valuable territories, top-performing salespeople or complementary product lines.

Your advisors can also help you take relatively simple steps to enhance your business's attractiveness and potentially boost its price. For example, you may need to clean up your workplace, repair or dispose of nonfunctioning equipment and ensure that your employees look and behave professionally.

BE REASONABLE

However you arrive at a value for your business, keep in mind that you'll need to remain flexible and open-minded throughout the M&A process. Potential buyers will have their own opinion of your company's value; and if the parties' positions are vastly different, price negotiations are likely to go nowhere. □