

2014

COMPLETE GUIDE TO MIDDLE MARKET M&A





Introduction

Dear Readers,

Thank you for downloading The Complete Guide to Middle Market M&A 2014. This ebook is a collection of the most valuable and popular articles published on Axial's Forum. The included content, written mostly by fellow deal professionals and business owners, discusses the key trends in the middle market and best practices for navigating the transaction process.

The 75+ below articles reflect the diversity of the middle market community and cover a wide range of topics and themes. As a result, this ebook is divided into seven chapters:

- Chapter One:** Hiring an M&A Advisor
- Chapter Two:** Finding the Best Buyers
- Chapter Three:** LBO Essentials
- Chapter Four:** Leveraging Technology
- Chapter Five:** Completing the Best Transaction
- Chapter Six:** Trends Shaping the Middle Market
- Chapter Seven:** Valuation Best Practices

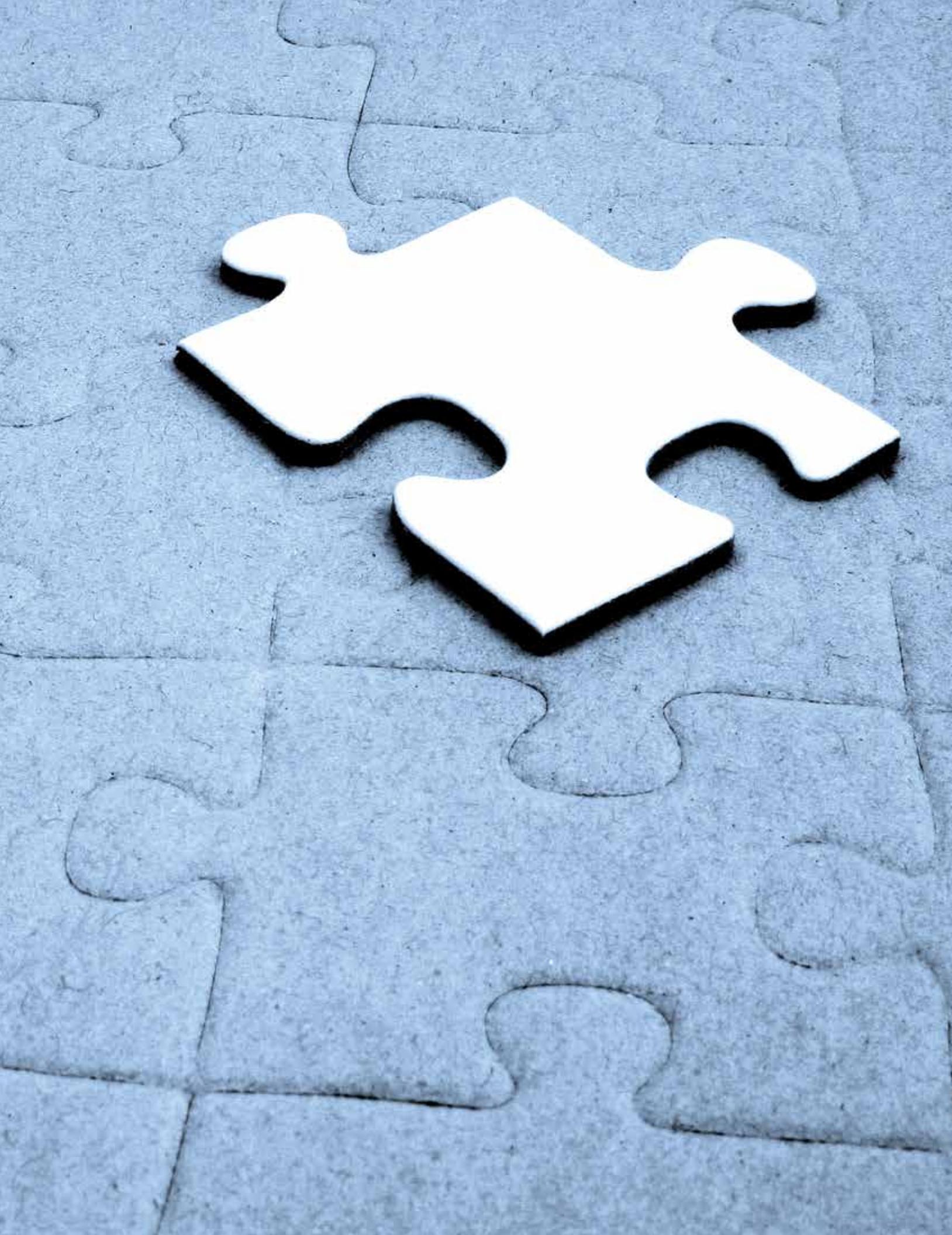
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Happy reading,

Billy Fink
Editor, Axial Forum

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M&A Advisors: The Overlooked Value Maximizer

By Dan Lee | June 10, 2014

One of the biggest mistakes CEOs make when selling their business is underestimating the value that a seasoned and qualified M&A advisor can bring to a transaction. All too often, business owners reduce the role of M&A advisor to a glorified networker. It's little surprise, then, that so many entrepreneurs are dismissive of seemingly exorbitant fees charged by advisors for what they perceive to be very little work.

With few exceptions, this misconception couldn't be further from the truth. While it's certainly possible for business owners to sell their company on their own, they'll likely make (very) costly mistakes throughout the transaction process. These mistakes can be avoided by hiring an M&A advisor. In fact, M&A advisors play a critical role throughout the sale process that sellers often overlook.

Here are the critical ways in which the right advisor can more than earn their fees:

UNDERSTANDING YOUR GOALS AND STRATEGIC PLANNING (6 MONTHS – 3+ YEARS)

Though you might think you have a pretty good idea of what a successful exit outcome looks like, experienced advisors can (and should!) make you realize that there may be more considerations than price when selling your company. This is why it's important to begin developing formal relationships with advisors at least 2-3 years before you think you might sell – it takes time to build trusted relationships with someone who

understands your personal goals, and can help you undertake the strategic planning efforts that will help you achieve them.

Valuation

Valuation expectations will need to be a large part of your initial conversations with an advisor. While your personal goals in a transaction may not be limited to value maximization, your advisor will try to understand your expectations, adjust them as necessary, and let you know what else you might need to do to meet your valuation goals. Valuation is a careful equation of the buyer, the timing of the transaction, the state of the business, industry-specific trends, and macro trends. Advisors have a sense of all of these factors and can help direct the process to align with your valuation goal.

Post-Transaction Goals

Business owners often have other personal goals in a transaction that can be just as important – sometimes more important – than money. Each of these personal goals — including your desire to stay after the transaction, earn-outs,

concern for company legacy, concern for management team, etc. — can change the nature of the process. An advisor knows the different strategies of each buyer type and can help align your interests with theirs.

Timing

Many business owners often pursue a sale for reasons that have nothing to do with the business. Perhaps they are burned out and want to retire, or unexpected personal circumstances have accelerated their transaction timeline. Whatever the catalyst, these situations can be dangerous, eventually causing the business owner to sacrifice transactions goals for expediency. It is during these moments that an experienced advisor can help balance the urgency created by personal timing issues with an outcome that still gets you a fair price for your business. However, this requires an established relationship and existing mutual understanding and trust.

Determining the Ideal Process

In addition to helping a business owner evaluate the transaction goals and timeline, a good M&A advisor can

help a business owner identify the best process for exiting the business. Since many closely-held businesses often experience intense family or shareholder dynamics, which may complicate the transaction, having a full understanding of the available options is essential. For example, if you want to sell the business to family or friends, a management buyout (MBO) or an Employee Stock Ownership Plan (ESOP) may be most appropriate. In the event you choose to pursue an external buyer, an advisor can then help you tackle the question of whether a financial buyer or strategic buyer is more appropriate.

TRANSACTION PREPARATION

(1-3 MONTHS)

When it's finally time to move forward with a transaction, your advisor is instrumental in the preparation of key materials and the actual logistics of the transaction.

Preparation of Marketing Materials

One of the most important M&A documents your advisor will prepare is the executive summary of your business, also known as the teaser.

The teaser is how your advisor will pitch your business to prospective buyers, summarizing your transaction goals as well as high-level highlights about your business' financial and operational performance, industry and market position, management team, competitive advantages, and any other differentiators. Private equity buyers and experienced corporate

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acquirers typically review hundreds if not thousands of teasers every year, so the teaser is a critical opportunity to make a strong first impression.

In addition to the teaser, your advisor will prepare a more comprehensive confidential information memorandum (CIM) and detailed financial statements for buyers who express initial interest in learning more about your company. These later documents will help the buyer evaluate if they want to move on in the process and meet you and your management team. Lacking these necessary documents may cause many potential buyers to not even consider your business.

Building a Buyer List

During this stage of the process, many advisors will also begin compiling a prospective buyer list. Your advisor's transaction experience and industry expertise will play a large role in their ability to build a diverse buyer list that not only helps maximize your potential valuation, but also enables you to achieve your non-valuation transactional goals.

Advisors will rely on their existing network of financial and strategic buyers, tools like Axial, and your own knowledge of potential acquirers to compile the list. Building the ultimate buyer list is part art and part science, and a qualified advisor can help you identify the most likely buyers for your business from among the thousands that may potentially be interested. As the list is being finalized, you and your advisor will review it to ensure you are comfortable with all of the buyers on the list and prioritize the list in tiers that the advisor uses

to stagger their outreach. Some advisors may also recommend "pre-marketing" the transaction at this point, where they may contact a handful of buyer contacts at the top of your list with whom they have long-standing relationships.

THE TRANSACTION (3-9 MONTHS)

Going to Market

The actual transaction process kicks off with your advisor "taking your company to market." This simply means that they begin the process of reaching out to potential buyers, and gauging their level of interest in your business. The initial outreach typically maintains your confidentiality, as the teaser is usually blind and does not disclose the identity of your business. This stage of the process is often broken down into multiple waves, as your advisor might first reach out to strategics (who typically take longer to respond with interest) and other buyers in the top tier of your buyer list. Buyers interested in learning more about your business will sign a non-disclosure agreement (NDA) and request the CIM.

Narrowing Down Candidates

As various buyers confirm their interest or withdraw from the transaction, your advisor will help you navigate the process of narrowing down buyer candidates. At this point you should expect to meet potential buyers in-person (known as "management meetings"). As the process progresses you should also begin receiving IOIs (indications of interest) and LOIs (letters of intent). IOIs are informal letters confirming a buyer's intent to purchase a company and usually include valuation guidelines, transaction structure and other terms, due diligence expectations, and a timeframe for closing. LOIs are more

formal, legally-binding agreements that serve as a precursor to the purchase agreement and describes the proposed transaction in more detail. The execution of an LOI almost always gives that buyer an exclusive period during which to conduct final due diligence before the transaction closes.

Negotiation and Final Due Diligence

If you've managed to generate interest from multiple buyers, your advisor has done a great job so far. However, their job is far from complete — they will continue to negotiating the final agreement. Remember that price isn't the only important consideration, and your advisor can help you evaluate the other important considerations in the LOI. Your advisor's ability to negotiate on your behalf can not only come in handy because of their experience in leveraging buyers against one another for the best terms, but also because they serve as a buffer to prevent any hard feelings in the negotiation process from affecting your relationship with the buyer post-sale.

Once you sign an LOI, your advisor will also be responsible for ensuring a seamless due diligence process. Depending on whether you have an existing relationship with an M&A lawyer, they may also help you round out your "deal team" as you finalize the purchase agreement and close the transaction.

Peace of Mind

Ultimately your advisor is able to add a tremendous amount of value to your transaction through their experience and expertise. As much as they are responsible for running your process as a trusted partner and advisor, however, they're also here to make sure that you can stay focused on running your business and not let

the transaction become a distraction that negatively impacts business performance during such a critical period. For transactions involving highly complex family or shareholder dynamics, your advisor can also serve as objective, third-party counsel that helps your business make decisions that maximizes a successful outcome for all stakeholders.

As you contemplate the role that an M&A advisor will play in your company's sale and the return on investment from retaining one, consider too the added peace of mind from being represented by someone you will come to trust with one of your most prized assets.

Business Owners, Preparing for a Transaction

duties to the client. It outlines the terms and scope of the advisory services provided. It rigorously details the economic points that go to the heart of the relationship.

When negotiated and structured properly, this contract can be remarkably powerful in aligning the investment banker's interests with your own.

When negotiated and structured properly, this contract can be remarkably powerful in aligning the investment banker's interests with your own. High degrees of

alignment will incentivize the banker to close a deal for you, with the optimal valuation and terms.

However to successfully negotiate this agreement, it's imperative that executives understand the perspective of the investment banker and the specific motives that will encourage a top notch transaction outcome.

Here are the seven most decisive points to cover in your engagement letter.

How to Write the Investment Banking Engagement Letter

By Kateri Zhu | June 25, 2014

The engagement letter is one of the most important agreements between your company and the investment banker.

It sets the stage for sellside processes, acquisitions, mergers, debt financings, and equity financings. It has an overwhelming effect on the quality and depth of the investment banker's

1. FEE STRUCTURE

Investment bankers will typically divide your advisory charges into two functionally divergent groups: a (1) non-refundable deposit or retainer, and a (2) success fee.

The retainer is usually a flat fee. While it's sometimes paid out at the beginning of the engagement, it's usually paid on a regular basis over the length of the mandate. The most common schedule is payout on a monthly basis.

While it's not directly linked to the completion of your transaction, paying a mutually agreed upon retainer is pretty standard and it demonstrates your level of commitment to the sale process. Similarly, the investment

banker should be putting a significant amount of work into preparing your company for sale and should correspondingly be compensated for his efforts as the work is completed.

However, the success fee — and not the retainer — should always be the most significant component of the total compensation. This gives both parties the best motives for an optimal outcome.

The success fee is usually paid out at deal close. It's based primarily on three things: (a) deal type (e.g., buy-side acquisition, sell-side process, financing, etc.), (b) the type of ownership sold (e.g., equity, senior debt, mezzanine debt, etc.) and (c) transaction value. It's often expressed as a percentage of the total transaction value and can also include a progressive pricing schedule. In other words, above a certain agreed-upon price threshold, the success fee percentage calculated off the transaction value will rise incrementally with price.

A progressive schedule is an effective way to design a strong incentive for the banker to help you realize a valuation that exceeds your goals.

2. EXCLUSIVITY

Giving exclusivity to an investment banker can be a daunting proposition.

Naturally when you mandate an advisor and his or her team fails to meet expectations, it's a tremendous setback with respect to time and financial resources. Moreover, reaching your goal of a closed deal has been likewise delayed. And finally, when or if you go back to market — presumably with a different banker — the fact you were already out in the market and could not get a deal done could negatively impact investors' views of your company.

However, nearly all qualified investment bankers will require exclusivity because a good banker is going to be putting

a significant amount of thought, time, and effort into preparing your team and your offering materials to go to market. The sale process will span several months and can result in a number of divergent outcomes. The retainer, as discussed, should be a small portion of their compensation and unfortunately, is also rarely sufficient to cover the amount of time a solid banker will invest in your deal process. High quality and trusted investment bankers take each mandate seriously and dedicate themselves to closing a successful transaction. How much of their time and energy would they be willing to risk if they're not your exclusive advisor?

Moreover, deal processes generally run better with one lead person or firm handling all buyer communication and negotiations. Fewer cooks in the dealmaking-kitchen typically correlates with smoother, more focused, more expedient, and ultimately more effective

transaction processes.

Nonetheless, during your banker selection and negotiation process you'll certainly have the option to deny exclusivity to a banker. Simply note that the choice against giving exclusivity may limit your ability to get a top investment banker in your corner.

3. LENGTH

The term length specifies how long the engagement — and therefore the accompanying exclusivity — lasts.

A six to a twelve month term is pretty standard. This allows time for your banker to position the company, send out teasers to potential buyers, prepare the confidential information

memorandum, solicit interest, get disclosure agreements signed, coordinate with buyers during their due diligence processes, receive offers, and negotiate a deal.

However standard length aside, the engagement term you negotiate should be driven by two things: (a) how much time your advisor needs to close your specific deal and (b) how long you can be reasonably bound to an exclusive relationship with that advisory team.

4. TERMINATION

Moreover, your letter should explicitly outline the rights of termination after the term of mandate. Generally speaking, most agreements are drafted to automatically renew on a monthly basis until canceled, in writing, by either you or the banker.

5. TAIL PERIOD

The tail period is also a standard feature of engagement letters.

A tail is a length of time after the official term during which a transaction close would still result in advisor compensation. Typically, the tail period will be twenty four months. It's in the interest of the client to seek a shorter rather than longer tail period.

Deal processes generally run better with one lead person or firm handling all buyer communication and negotiations.

Tail periods are overwhelmingly common. This is primarily because deal processes are (a) frequently delayed for a variety of reasons and (b) dependent on a number of players. It would be reasonable to compensate your banker, subject to some time constraint, should the ultimate buyer be someone who was introduced by his or her team. For example, if a seller and investor are connected by the intermediary and begin negotiations,

undertake diligence, but fail to finalize a purchase agreement during the official term, the intermediary should nonetheless be given credit when they close a deal nine months later.

Therefore, the fundamental purpose of the tail is to make sure that the advisory team is compensated for their work when a deal is started, but not consummated, within the mandate term. Moreover, the tail also precludes a client from terminating an engagement immediately prior to deal close in order to dodge the majority of the advisory fee.

All this said, there are a number of reasons why a deal unrelated to your advisor's efforts can likewise close after the official term. For example, if a buyer emerges two years later as a direct result of your efforts or the efforts of another intermediary, it would be unreasonable to pay the original investment banker. As a result, clients will add safeguards to the tail provision in order to limit it to its intended purpose.

The most common safeguard is a requirement that the tail apply only to deals with an investor or buyer that was connected by the intermediary to the client during the official mandate term. Definitions of "connected" can differ across mandates, but you should minimally negotiate to restrict the pool of buyers triggering payment during the tail to those counterparties who received information from your advisor, expressed an interest, and signed a confidentiality agreement.

6. EXPENSES

Your banker will always incur reimbursable out-of-pocket expenses such as travel, research and material preparation during the sale process. Most engagement letters will explicitly

dictate that the client will cover any expenses incurred by the advisor in the performance of its services.

Nonetheless, it's in your interest to draft the letter such that you maintain the ability to exercise some reasonable control over these expenses.

For example, clients frequently request that the banker provide a monthly report outlining the expenses incurred by his or her team. Additionally, it's standard to place a ceiling on the dollar sum of reimbursable expenses, barring pre-approved exceptions in excess of said ceiling. Moreover, it's not uncommon to limit reimbursable expenses to external, third-party, out-of-pocket costs. And finally, the agreement should explicitly indicate that violations of these provisions will result in the expenses not being reimbursable.

7. COVERAGE

A sale process can result in a wide range of outcomes, from selling only a portion of the company for a minority equity position, to raising mezzanine debt, to launching a strategic joint venture. Consequently, it's important that the scope of services provided and covered transactions are well defined.

This provision will mitigate the probability that certain deals are not unintentionally roped into the confines of your contract or subject to inappropriate fee structures. For example, ultimately raising mezzanine capital may be a great outcome for you. However, the fees due to a banker for raising mezzanine capital are usually significantly lower than raising a comparable quantity of equity capital.

Your primary goal in negotiating the engagement coverage should be to (a) balance a well defined scope of engagement while (b) concurrently maximizing the services of the investment banker to explore all possible outcomes that will satisfy your goals.

Business Development, Business Owners, Preparing for a Transaction, Transaction Process

Understanding Investment Banking Fee Structures

By Cody Boyte | March 4, 2014

Investment banking is a sophisticated and exclusive field, so it's little wonder its innerworkings are hard to grasp. Pair the lack of clarity with the high stakes, and many business owners are tentative when engaging advisors.

While investment banking services don't come cheap, an experienced and well-connected advisor can be a godsend when raising capital or selling your company. The value a shrewd banker adds to the outcome far eclipses the cost.

That being said, it can be hard to weigh the costs and benefits without understanding how fees are calculated.

Though most fees and fee structures will be negotiated between the business owner and

While investment banking services don't come cheap, an experienced and well-connected advisor can be a godsend when raising capital or selling your company.

advisor on a deal-by-deal basis, there are a few terms to consider. Each can have a significant impact on the effectiveness of the advisor and potential outcomes during the deal.

UNDERSTANDING BANKING FEES

The fees in an M&A or capital raise process are structured to help smooth out the conflicts that can arise when a company is being advised by an investment banker. Bankers or advisors are often in a conflicted situation where, if the fees aren't structured well, it's better for them to sell a company for less money more quickly. That way they can move on to the next deal and make another fee. While it might be in your interest to get maximum value for your company, and waiting 6 more months for a better offer is no big deal, a bank has to keep the lights on and their advisory running.

Ensuring that a bank will push for the right outcome for your company comes down to getting the fees right. Banks, like everyone else, are driven by incentives. By ensuring the incentives in the fee structure are aligned

with your expectations will help drive the deal to the right result. Often that means that as a business, you'll have to decide whether you want a deal closed faster or for more money. The choice can have a significant impact on which banker to use and how to structure the fees. Well structured fees facilitate successful outcomes.

Nearly every banker structures their fees as some combination of a retainer and success fees. The split between retainer and fee, along with how the

success fee is structured, has the biggest impact on banker incentives. Understanding each can help you decide how to negotiate fees as you work with advisors.

RETAINERS

The retainer is the fee paid just to have an investment bank work on your transaction. It is non-refundable and paid in monthly installments or upfront as a lump sum. They tend to be highly negotiable: Bankers might waive a retainer for a surefire deal, while riskier projects could carry a steeper charge. This ensures that the advisor isn't left empty-handed if the deal flatlines.

The good news, though, is that money spent on retainer is usually credited against the success fee when the deal closes.

Ensuring that a bank will push for the right outcome for your company comes down to getting the fees right.

In general, retainers for larger transactions are usually north of \$100,000, or range from \$50,000-75,000 for a \$20-\$30 million deal, according to Basil Peters of Strategic Exits Corp.

Think hard about the riskiness of the company compared to the retainer being changed. Banks that charge a large

upfront retainer but shrimp success fees won't be strongly motivated to get a deal done, while those that tout a success-only model probably do not close a greater percentage of deals, just a greater number.

SUCCESS FEES: LEHMAN STYLE

The bulk of a banker's pay comes from the success fee. And how is the success fee calculated? Again, the percentages and terms vary on a case-by-case basis, depending on the size and complexity of the deal, the nature of the transaction (equity raises are a

bigger lift) and final outcome, among other considerations.

Starting in the '70s and '80s, success fees were based on the Lehman Formula. Originally applied to financing engagements, formula was made famous as a template for M&A transactions. In a nutshell, Lehman is a 5-4-3-2-1 structure: 5 percent of the first million dollars, 4 on the next million, and so on, scaling down to 1 percent.

Today the formula is still a popular way of structuring success fees, though inflation has made the traditional numbers unworkable. Instead the Double Lehman scale is more prevalent: 10 percent of the first million dollars, 8 percent of the second, 6 of the third, 4 of fourth and 2 of everything thereafter. Variations on the structure have also become more common, tailored to each deal. The Modified Lehman scale takes 2 percent of the first \$10 million and a lesser percentage of the balance.

SUCCESS FEES: NON-LEHMAN

Though variations of the Lehman Formula are still very popular, different structures are starting to be used by different firms. In particular, rather than reducing fees as a deal gets bigger, some firms actually increase their fees as they generate a higher sales price.

"Many would argue that the most sensible formula is one where the percentage of the consideration increases the higher the selling price, thereby providing a better incentive to maximize price and not recommend the easy deal," M&A expert Edwin Miller, Jr., writes.

Escalating success fees above certain benchmarks is one way to incentivize bankers towards larger outcomes — i.e. 1.25 percent of first \$100 million of value, 1.5 percent on value between \$101 and \$125 million,

2 percent thereafter. But regardless of the scale, the logic behind compensation is to incentivize the banker to do his or her job. That means resisting the quick solution and driving towards superior terms.

In terms of strict success fees, the biggest deals aren't always the most expensive. Often larger deals, while somewhat risky, can be completed more easily than mid-market deals. Mid-size exit transactions often carry higher percentages because the deals are trickier to finesse, involving fewer and less experienced buyers.

OTHER FEES AND EXPENSES

It may seem obvious, but it is worth noting that fees are determined by the value of the deal, not the proceeds to the seller. That is, bank debt or other liabilities may reduce the seller's payout but not the fee base.

And timing is another issue. Bankers often want to be paid at closing, which is reasonable in connection with a cash sale. However it gets more complicated, and more negotiable, when deals involve different financing components, like deferred payments, capital adjustments and promissory notes.

Aside from retainer and success fees, targets will have to reimburse the banker for deal-related expenses, like travel, which on a large transaction can become significant.

Deal-making discourages transparency, but it never hurts to simply ask the banker how fees were structured for comparable deals. It might reveal much, especially if the transactions involved private companies, but even general outlines make the process less inscrutable.

Business Owners, Preparing for a Transaction



Should You Keep Your Sellsid Process Narrow?

By Kateri Zhu | May 14, 2014

One of the single most challenging aspects of selling a business is getting your buyer pool right.

While you certainly want to include enough buyers to complete the transaction, you also want to avoid sharing proprietary company information with more people than necessary. How do you balance the drawbacks of running a broad process with the benefits of having enough high quality buyers involved?

Theoretically, it would seem prudent to keep your buyer pool tight. Historically, sellside bankers would frequently brainstorm a long buyer list and then trim the pool down to a handful that they believe to be the most likely acquirers. The only buyers invited to the bidding process would ultimately end up being those on that shortlist.

However, evidence shows that unless you have a compelling reason you should go broad, broad, broad.

First, despite what many may believe, it's often an unexpected buyer that ends up being a game changer. Joe May, Managing Principal at Graham Partners and Axial Member, explains that "bankers will sell an asset to someone in their top tier of buyers 55% to 60% of the time. That means that 40% to 45% of the time, the buyer is going to come from outside the top tier."

This demonstrates that even for bankers with decades of execution experience, it's exceptionally difficult to accurately identify the most likely buyers.

Moreover, casting a wide net aligns with a sellside investment banker's obligation to maximize value for their client. All else equal, more buyers translate to a more competitive process, and competitive deals beget more competitive pricing.

"Bankers will sell an asset to someone in their top tier of buyers 55% to 60% of the time. That means that 40% to 45% of the time, the buyer is going to come from outside the top tier."

Similarly, the same principle applies to capital providers selling a portfolio company. The vast majority of fund

managers are measured by the internal rate of return and cash on cash returns that they produce on their investments.

While there are privacy, resource, and process considerations that come with broad deals, the higher your sale price the stronger your IRR, and the stronger your buyer list, the better your chances of ultimately securing a robust sale price. Adds May, "in order to maximize value for our investors, we typically go a bit broader." At the end of the day it's truly a numbers game.

Adam Abramowitz, Senior Vice President at Intrepid Investment Bankers, concludes "as much as you might think you know who the likely buyers are, until you pick up the phone and talk to a decision maker, you never know for sure." The one consistent way to mitigate the amount of money you leave on the table is to cast a wide net and start broad.

Business Owners, Data & Analysis, Deal Professionals, News & Trends, Preparing for a Transaction, Valuation

Should Your Buyer List Include Financial Sponsors?

By Kateri Zhu | May 7, 2014

There are two kinds of buyers: financial buyers and strategic buyers. Financial buyers, often called 'financial sponsors' or just 'sponsors', include any company that invests as a business: private equity funds, family offices, commercial lenders, mezzanine funds, independent

investors, and other capital providers. Strategic buyers include effectively everything else: the industrials business buying an original equipment manufacturer, the media company buying a software provider, and so on.

However, the primary tradeoff is that financial sponsors are usually unable to pay as much for a business as strategic buyers can (details on why below).

The question: Is it better to limit sellside deal processes to strategic acquirers or is there a sizable benefit to including financial sponsors?

BACKGROUND

There are two core reasons why financial sponsors tend to be unable to pay as much as strategic acquirers.

First, sponsors are under pressure to hit a target return percentage on the money they invest — which puts a restraint on their entry price into every investment. They're not obligated to meet these return targets, but their ability to do so makes a dramatic difference for (a) the amount of carry received upon exit, (b) future management fees and (c) whether future funds can even be raised. The three main drivers of returns are entry price, exit price, and leverage. Consequently, buyers are rightfully focused on pricing for a certain internal rate of return (IRR) during the acquisition process.

Secondly, sponsors usually* can't benefit from the operational synergies that frequently result from strategic deals. Synergies occur when two companies perform stronger financially than they do individually. This generally results from cost reduction, joint talent and technology, or cross-market revenue growth. For this reason, synergies almost always accompany strategic acquisitions and are often

a driving force behind how much a buyer is willing to pay. For financial sponsors however, unless the deal is an add-on to an existing portfolio company, they structurally can't benefit from operational synergies. The absence of these sizable benefits puts a ceiling on how much the business is worth to them, and correspondingly, their upfront offer.

Despite these limitations however, experience shows that it is actually almost always a good idea to include financial

sponsors in your buyer list. Here are the primary benefits.

DEAL DISCIPLINE

First, having financial sponsors in your sellside process helps with deal discipline and pacing. Anyone who has ever tried to sell a business will tell you that there are about 1,000 roadblocks that you'll have to hurdle to actually close a deal. Between buyers needing more time, being unable to make decisions, wanting more information, and unexpected hiccups, even the most veteran M&A bankers have an exceptionally tough time running an expedient process.

However financial sponsors, as the name denotes, are in the business of sponsoring business growth. Because of this, they're veterans when it comes to sellside deals and will typically go through dozens of processes a year.

As a result, sponsors tend to have an excellent grasp of structure and pacing: knowing what the standard transaction looks like, exactly what the next step is, and when you should be there. They know how a normal NDA looks, when to submit it, what needs to be in the data room, and how to structure an LOI.

Moreover with multiple parallel deal processes running, investments that the sponsor has to exit in the next few months, capital that must be put to use within a tight time frame, and their own timing restraints, having the financial sponsors on your buyer list will help keep the process on track and moving forward.

Having the financial sponsors on your buyer list will help keep the process on track and moving forward.

DEAL CERTAINTY

Secondly, involving financial sponsors in your sellside process typically improves deal certainty. Because sponsors are generally driven by a return targets, the

amount that they're willing to pay will be predominantly based on the exit price, forecasted performance, and the IRR that they need to hit. They will then use these restrictions to solve for the entry price.

Consequently, while they generally pay less than strategics, sponsors are often happy to come to the table at some price level.

Eliot Peters, Managing Director at RA Capital Advisors** adds that he will include financial sponsors on his buyer lists "no matter what." Not only does it help with deal discipline, but "it gives you deal certainty, because they're always there at a price." To have someone like that in your process gives you a safety net, or insurance, which is something that anyone trying to sell a company could only hope to have.

**This applies unless the acquisition is an add-on to an existing portfolio business. In that case, the combined company is much more likely to realize either cost synergies or revenue synergies. The financial sponsor will then incorporate these bottomline savings or topline gains into their valuation of the business and will be able to pay a commensurately higher price.*

***Registered broker-dealer and member of FINRA/SIPC*

5 Differences Between Financial and Strategic Buyers

By Cody Boyte | February 6, 2014

As you sell your company or raise funding, understanding the key differences between strategic and financial buyers can help you understand their decision-making processes. Clarifying what each type of buyer is seeking can help you decide which fits your situation best.

As a quick refresher, potential buyers / investors fall into two primary categories:

STRATEGIC BUYERS

These are operating companies that provide products or services and are often competitors, suppliers or customers of your firm. They can also be unrelated to your company but looking to grow in your market to diversify their revenue sources. Their goal is to identify companies whose products or services can synergistically integrate with their existing P/L to create incremental long-term shareholder value.

FINANCIAL BUYERS

These include private equity firms (also known as “financial sponsors”), venture capital firms, hedge funds, family investment offices and ultra high net worth individuals (UHNWs). These firms and executives are in the business of making investments in companies and realizing a return on their investments. Their goal is to identify private companies with attractive future growth opportunities and durable competitive advantages,

invest capital, and realize a return on their investment with a sale or an IPO.

Because these buyers have fundamentally different goals, the way they will approach your business in a M&A sale process can differ in many material ways. There are five primary ways they differ:

EVALUATION OF YOUR BUSINESS

Strategic buyers evaluate acquisitions largely in the context of how the business will “tie in” with their existing company and business units. For example, as part of their analysis, strategic acquirers will ask questions like:

- Are the products sold to their customers?
- Does your company serve a new customer segment for them?
- Are there manufacturing economies of scale we can realize?
- Is there intellectual property or trade secrets that you’ve developed that they want to own or prevent a competitor from owning?

Conversely, financial buyers won’t be integrating your business into a larger company, so they generally evaluate an opportunity as a stand-alone entity. In addition, they often buy businesses partially with debt which causes them to scrutinize the business’ capacity to generate cash flow to service a debt load. Financial buyers are also focused on understanding how to quickly increase the long-term value of the company to ensure an acceptable return on their investment.

While both buyer groups will carefully evaluate your business, strategic

buyers focus heavily on synergies and integration capabilities whereas financial buyers look at standalone cash-generating capability and the capacity for earnings growth.

One note of caution is that all buyers cannot be nearly categorized.

Because these buyers have fundamentally different goals, the way they will approach your business in a M&A sale process can differ in many material ways.

Sometimes ‘strategics’ are just looking to boost their earnings and end up acting like financials. Other times, ‘financials’ already own a company in your space and are looking to make strategic add-ons, so they’ll evaluate your business more like a strategic. By understanding the motivations of the buyer, you can understand how they’re determining your business value.

DETERMINING THE INVESTMENT MERITS OF THE INDUSTRY

Strategic buyers usually are more “up to speed” on your industry, its competitive landscape and current trends. As such, they will spend less time deciding on the attractiveness of the overall industry and more time on how your business fits in with their corporate strategy. Conversely, financial buyers are typically going to spend a lot of time building a comprehensive macro view of the industry and a micro view of your company within the industry. It is not uncommon for financial buyers to hire outside consulting firms to assist in this analysis. With this analysis, financial buyers might ultimately determine they do not want to invest in any company in a given industry. Presumably, this risk is not present with a strategic buyer if they are already operating in the industry.

As the seller, the risk of having a sale process fail due to “industry

attractiveness” factors is reduced by ensuring that you are soliciting strategic buyers.

STRENGTH OF BACK-OFFICE INFRASTRUCTURE

Strategic buyers are going to focus less on the strength of the target company’s existing “back-office” infrastructure (IT, HR, Payables, Legal, etc) as these functions will often be eliminated during the post-transaction integration phase. Since financial buyers will need this back-end infrastructure to endure, they will scrutinize it during the due diligence process and often seek to strengthen the infrastructure post-acquisition.

As such, you’ll likely want to de-emphasize the importance and/or value of your back-office infrastructure in discussions with a strategic, whereas it’s important to be prepared for thorough evaluation of these functions when having discussions with a financial buyer.

THE IMPACT OF THE INVESTMENT HORIZON

Strategic buyers intend to own an acquired business indefinitely, often fully integrating the company into their existing business. Financial buyers typically have an investment time horizon of four to seven years. When they acquire and subsequently exit the business, especially in the context of the overall business cycle, will have an important impact on the return on their invested capital.

For example, if your business is purchased at the peak of a business cycle for 8X EBITDA and the buyer can only sell it for 6X EBITDA 5 years later, it’s tough to make an attractive return. As such, financial buyers are going to be more sensitive to business cycle risk than strategic buyers, and they will be thinking about various exit strategies for your company before making the final decision to invest in / buy your company.

TRANSACTION EFFICIENCY

Financial buyers are in the business of making acquisitions. It is one of their core competencies to execute deals in a timely fashion. Strategic buyers may not have a dedicated M&A team, may be encumbered by slow-moving boards of directors, bureaucratic committees, territorial division managers, necessary to check acquisition against internal projects, etc.

From our experience, combine these factors and the process with strategic buyers can often take longer than with financial buyers. No matter what, be prepared for a 6-12 month process before you decide to sell.

There is more to be said about the many important differences between strategic and financial buyers, but these are the basics.

Business Owners, Preparing for a Transaction

To better understand how family offices are going about their direct investing strategies, Wilson surveyed his network and found some interesting qualities about the direct investments.

THEY PREFER MAJORITY INVESTMENTS...

When a family office makes a direct investment, it almost always prefers majority investments. As Wilson explained, “Some [family offices] would like a strong majority leader, but almost none are looking to make 50, 100, or 200 minority investments.”

Making minority investments in private companies is less beneficial for many single and multi-family offices. “If they wanted to take a bunch of minority investments, they might as well go into public markets, buy some shares, and have more liquidity and transparent reporting at the same time.”

By making majority investments instead, these families can offer more real strategic guidance to the business. “Since most family offices are founded around entrepreneurs, they understand the markets and industries. As such, most of these families see industry experience and knowledge as the source of their money,” explained Wilson. “They enjoy working in these types of businesses and it is natural to them to have confidence in making more money or preserving their family’s worth this way.”

Majority investments within their core industries allow family offices to use their experience to build the business and generate solid returns — a favorable combination for both the entrepreneur and the family office.

...BETWEEN \$500K – \$5M

According to Wilson’s survey, “the largest volume of survey respondents are making \$500K-\$5M sized-investments.” While 48% of family offices were looking to make

How Family Offices Approach Direct Investing

By Billy Fink | April 15, 2014

The trend of direct investments by family offices continues to develop momentum. “Direct investing has become very popular with both single family and multi-family offices,” explained Richard Wilson, founder of the Family Offices Group. “Nearly every family I know has exposure to direct or co-investments.”

The decision to adopt hands-on investments is a reaction to family offices being dissatisfied with “getting burned in the public markets and trusting other people with large amounts of their money,” says Wilson.

investments between \$500K – \$5M, only 11% were looking to make investments larger than \$25M.

This preference for smaller deals has less to do with strategy than budget. “Families with [funds of] \$50M-\$200M are more common than families with \$1B+,” explained Wilson. Unsurprisingly, the size of the check generally corresponds with the size of the family office. After appropriate portfolio diversification, smaller families can only write smaller checks.

Wilson continued, “I know that our \$1B+ clients almost always want to write checks at a \$5M minimum and it is only those single family offices looking for concentrated positions in just a few industries or those larger \$500M-\$1B+ group who are looking to do the \$20M-\$100M size deals. While looking closer at the data it is the larger single family offices and those families who have built out fully formed private equity fund or private equity portfolio divisions which are conducting these larger deals.”

THEIR BIGGEST CHALLENGE

Like any dealmaker, one of the biggest challenges confronting family offices is deal flow. “Many of these families don’t know how to find the relevant partners or dealflow,” explained Wilson.

“They do not know who to trust, and they don’t have a lot of connections in the network.”

Since family offices have traditionally maintained a discreet profile, it is difficult for intermediaries and business owners to contact them.

Like any dealmaker, one of the biggest challenges confronting family offices is deal flow.

As a result, there is a new trend in which family offices are becoming more public. “They want to be known in the marketplace to the right parties because they want the deal flow. Not many have this mindset today but that is a very early trend I’m just now starting to see this year and I’m sure will continue,” said Wilson. “There are new family offices starting every day. As the industry grows, there will be family offices that are set up that recognize the benefits of being public.”

We are already seeing this increased publicity on the Axial network. Over the last three years, the number of family offices on the network has grown 205% percent. Additionally, these family offices are resolving their dealflow issues by becoming more active –the average family office pursued 20 opportunities in 2013, up from only 6 in 2011.

Deal Professionals, Dealmaker Outlook, Preparing for a Transaction

to London to discuss co-investment opportunities with a \$2B and a \$5B+ family, and while in town I recorded a BBC World News TV interview on \$1B+ families and their single family offices. Much of the interview focused on why these families are not spending more of their money to help the economy, the perceptions of the ultra-wealthy, and what it is like to work with them every day.

Below are some of the most common misperceptions:

THESE FAMILIES DIDN'T FALL INTO THEIR MONEY

None of the families that I have met to date have come into wealth through pure good fortune, such as winning the lottery, or finding gold on their horse ranch, etc. Instead, almost all of them have all started and grown successful businesses and worked long hours over a long period of time.

These families are largely savvy investors in their own right, they have earned their wealth through navigating their industry and often leading it. This means that investment bankers and private equity funds approaching them should learn about where they made their wealth, how, and think of creative ways to work together instead of just pitching deals to these wealthy families. Many times families can be a source of deal flow, domain expertise, and capital over a given period of time.

SECRETIVE BUT NOT HIDING

While family offices and \$1B+ families are seen sometimes as secretive, hard-to-access, and under-the-radar, they are everywhere. They are behind the charities we hear about, backing the venture capital funds, owning the sports teams we cheer for, and refining the oil going into our cars. They are omnipresent yet secretive at the same time.

Family Offices: Fact vs. Fiction

By Richard Wilson | *The Family Offices Group* July 16, 2014

It is surprising how often family offices and the ultra-wealthy are misrepresented in the media and how these misconceptions can lead to a negative view of the industry overall.

As part of my work with larger single family offices — our team runs a family office community with 77,000 global members, 2,000+ of which are single family offices — I recently traveled

Many family offices are secretive because of a desire for the wealthy family to live a semblance of a normal life, without the scrutiny of journalists commenting on their every vacation or business stake. Also, the family office industry is so new that just now many organizations are starting to self-identify as a single family office instead of a holding company or loose team of professionals stewarding the wealth of an ultra-wealthy family.

As single family offices grow in number and maturity they should become less secretive and a segment of them will employ public relations consultants and team members to help grow their equity interests connected to the family office and increase deal flow.

WORKING WITH LARGE FAMILY OFFICES

As I explained in a recent interview I have found these large family offices to be highly professional and respectful of time. While they are very busy, they do take time to identify high-quality partners and products – prioritizing recommendations from their peers as high quality resources. While these families have excess wealth, if you can provide genuine insight on your area of niche expertise, you will be seen as valuable for the unique knowledge-currency you possess.

DON'T BELIEVE THE GOSSIP HEADLINES

Most newspaper headlines on the ultra-wealthy focus on wasted money, crashed Ferrari's, family disputes, or other negative aspects of being very wealthy. There are many family disputes, but what goes on with these families is far from what the media portrays and is not consistently negative. Some may disagree, and this is as political as I ever get, but I believe

While these families have excess wealth, if you can provide genuine insight on your area of niche expertise, you will be seen as valuable

as a society we are playing the game of capitalism and with the exception of a few corrupt politically connected billionaires, the rest of these individuals are winners of this global game that we play. They should be studied, learned from, respected, and seen as such.

Deal Professionals, Dealmaker Outlook, Fundraising & IR

5 Reasons to Sell to a Family Office

By Ashleigh Schap | September 30, 2014

Twenty five years ago, the average CEO was pushing 60 years of age; today, the average age is closer to 54. What that means for the capital market is that exit horizons have shifted – and so have the strategies CEOs are using to sell their businesses.

In the early 90s, CEOs were considering more immediate exits as they were closer to retirement age. Now, the average CEO still has more than a decade left in the workforce. But with markets at an all-time high, many are looking for ways to take some capital out of their businesses without giving up total control.

Traditional acquirers don't always make a perfect match for these situations, leading many of today's executives to work with family offices. Here are 5 of the biggest reasons why:

THEY HAVE LONGER INVESTMENT HORIZONS

One of the biggest advantages of selling to a family office is their much longer investment horizon. Most traditional investors — like private equity firms — are limited to 5-7 year investment timelines because of fund-imposed limitations. Since PE firms must return money to their GPs at the close of the fund, they are limited in how they can think about investments and what strategies they prioritize. As a result, many CEOs feel their PE-backers are too focused on the short term.

Family offices, however, are not limited to any specific timeline. This is because family offices do not have any fund structure; they are investing with their own money and can do so at their own timeline. They can hold companies for extended periods, allowing younger CEOs to stay on and grow the company or to sell with a much longer buyout period. This longevity is particularly appealing for CEOs that are not looking to exit entirely, but merely take a few chips off the table and begin planning for a transition.

THEY HAVE STREAMLINED DECISION MAKING

Family offices tend to be more streamlined in their decision making processes. Since they are using their own money and are often investing within their industry of expertise, they feel more comfortable making quicker decisions and have more flexible internal operations.

In contrast, private equity firms often need to conduct robust due diligence processes and consider the interests of their GPs. These extra steps can add significant time and complications to the entire process.

THEY ARE A BIT MORE HANDS OFF

Additionally, family offices are often not interested in taking over the management of the company. When they make an investment, it is usually to encourage the already-existing growth of the company. This makes them an ideal investor for an owner that is looking to stay on for another 5-10 years.

Private equity firms and strategics, depending on their strategy, can often be more heavy-handed with their management strategy. They may change the strategic direction of the company or bring in new senior management to better accomplish their goals. Similarly, strategic acquirers will often roll the acquired business into a larger company.

For a CEO looking to stay in place, the heavy-handed tactics can be a deal changer. Regardless of the investor, it is important to always discuss goals and expectations at the very beginning of the process.

THEY PAY IN CASH

PE firms will often pay for a portion of their acquisitions with cash and will finance the rest using mezzanine or senior debt, ultimately transferring debt to the target's balance sheet. While this leveraged buyout strategy can encourage rapid growth and better returns for the PE firm, it also entails a bit of risk. And often, since a CEO is attempting to reduce their personal risk by taking chips off the table, this can be a choice they're unwilling to make.

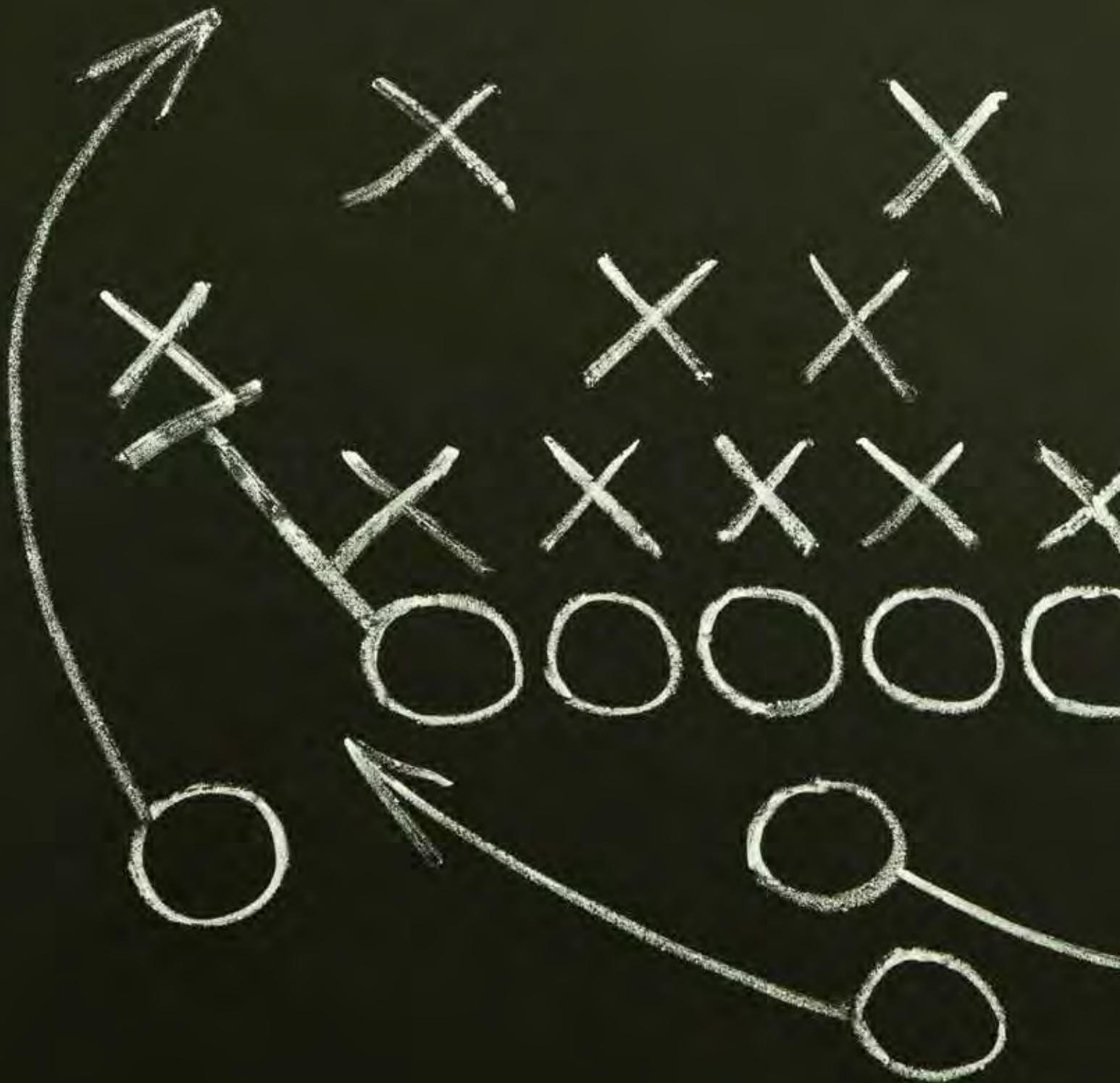
Family offices, however, rarely use debt to finance their acquisitions. Instead, they prefer to pay in cash. This relieves the company from the debt burden often taken on by other types of financial buyers and leaves the company in a better position to weather future issues.

THEY HAVE INDUSTRY EXPERTISE

Most people prefer to stick with what they know; billionaires are no exception. As such, family offices tend to invest in the industry in which they made their fortune, providing an invaluable source of advice and market expertise for executives that stay on to run the company.

There are plenty of great reasons for companies, particularly those with younger CEOs and executives to sell to family offices. Ultimately, it's an option that can provide more freedom for both acquirer and target. Family office participation in direct acquisitions has increased in recent years, and will only continue to increase as the ultra-wealthy seek new ways to engage with the capital market.

Business Owners, Due Diligence, Preparing for a Transaction



Inside the Leveraged Buyout Deal Process (Part I of III)

By Kateri Zhu | April 2, 2014

What does a leveraged buyout transaction look like?

In this three part series we will give readers a look behind the curtains of one of the most captivating types of deals on wall street: the leveraged buyout (“LBO”).

There are ten primary steps to an LBO. This is the first installment of our trilogy and will cover the first four steps: sourcing, screening, the non-disclosure agreement, and due diligence.

STEP I: SOURCING

Before a buyer ever talks to a seller, before any negotiation happens, before a deal even gets off the ground, there's a fund partner sitting somewhere in America looking at the entire universe of deal opportunities and deciding on which one he wants to spend the next six years of his life.

This is what we call sourcing.

During the sourcing stage, the primary player is the buyer. He's combing the landscape, sifting for enterprises possessing certain core traits, researching them, weighing (and recording in acute detail) investment risks and benefits, and using all this knowledge to inform his next move.

Fund partners turn to several channels in this process. First, they'll reach out to personal contacts including associates at other funds, investment bankers in the sector, and company executives with whom they have relationships cultivated over many years. Second, they'll use dealmaking tools such as Axial and LinkedIn to substantively improve sourcing scale

and reach. And finally, they'll use databases such as Capital IQ, Factset, and Bloomberg to make sure that they're not missing something of which every other market player is aware.

The primary driver of LBO returns is the degree to which the investor is able to source on a comprehensive level. Why is this the case? Because in order to generate a strong internal rate of return (“IRR”) a fund needs to be able to both deliver extremely profitable improvements to the business, and buy it for a fair price at the start of the deal. Unfortunately, most transactions are auction processes wherein multiple capital providers — each with strong capabilities — are all bidding on the same asset. As a result, funds that have identified channels that enable them to source efficiently are almost always able to access proprietary deals that end up delivering huge dividends.

STEP II: SCREENING

Once a capital provider has potential targets on the table, a rigorous screening exercise commences. The goal of this process is first to reach a

shortlist of high-value opportunities and ultimately to agree on a single target that it will pursue to deal close.

The skill with which a fund is able to identify the right target is arguably the second most influential factor on performance, next to its ability to source at scale. Indeed, there are a number of critical factors that make a good buyout candidate but every fund's angle is different. As a consequence, the process by which a fund selects the opportunities with which it has the best angle is of critical importance to its financial success (defined predominantly by IRR).

During this stage, a fund will typically take from several days to several weeks to construct a robust view of a business. First, it'll start with whatever public information the company has made available. This will include anything on the website, press releases, shareholder presentations, customer pamphlets, ownership change announcements, and any financial figures the management team has released. If the deal opportunity arrived on the investor's

desk as a result of a teaser from an investment bank, he'll also look over any business or financial data disclosed in that document.

Second, he'll comb the landscape for anything that may shed light on the core foundation and health of the business. This includes third party news mentions, independent profiles on the business and its leadership team, customer testimonials, customer complaints; basically, anything that he can find on Google, and beyond. This is a critical step as — similar to a product you would consider buying in a store — third party commentary is often more comprehensive when it comes to the good, the bad, and the ugly.

The partner then undertakes a thorough assessment of the industry in which the company plays. Who are the competitors? What are their relative market shares? What differentiates our guys? Who is the target consumer? Are there product or service substitutes? What are the performance drivers? What are the typical margins (e.g., gross margin, EBITDA margin, net income margin, etc.)? How much do players typically spend on capital expenditures, working capital, the like? What does the average accounts receivable and accounts payable cycle look like? Who are the upstream providers? How fast is the sector growing?

Fourth, the fund will take the data it does have and build a financial model of the potential transaction. The model answers the key question that fund partners ask themselves: what would the LBO look like if we were to execute it? It includes not only available (or often assumed) financial projections, but details on how much debt the transaction would entail (3.75x EBITDA? 4.50x EBITDA?), how much they would pay, how long they would hold it, how much value they plan on creating during the holding period (usually 3 to 10 years), what they would

do to create that value (reduce cost of goods sold? grow topline?), how much they would sell it for on the exit date, and what % return this all sums up to.

Finally, the fund will take all this information and aggregate it into a central document ranging from a brief investment overview to a comprehensive deal memo. The memo will include not only an overview of the company, the competitors, and the industry, but a thorough assessment of the risks and benefits involved with a buyout of the enterprise. Indeed, it's not uncommon for buyers to do a thorough round of internal analysis before they ever talk to a company owner.

STEP III: NON-DISCLOSURE AGREEMENT

If the buyer decides that it wishes to move forward, it'll want significantly more detail than what's publicly available or provided in the teaser. To access this data, he and the seller will sign a confidentiality agreement, also frequently referred to as a non-disclosure agreement ("NDA"). In short, the NDA is a legal document that protects any confidential operating and financial information shared by the buyer with the seller throughout the transaction process, from being disclosed with third parties.

The execution of the NDA officially kicks off the deal. It's the first point in which the potential investor is given access to information that any public bystander won't have. Moreover it's the first time that the buyer and seller will sit down at the table to negotiate. In more complicated transactions, either a sellside investment bank, sellside legal counsel,买方投资银行, buyside legal counsel, or all of the above, will also weigh in on the negotiations.

Here, the buyer will review a copy of the NDA, usually provided by the seller, mark it up with any changes it wishes

to make, send it back to the seller for approval or some negotiation and, when they have reached a consensus, send over a copy of the executed contract.

STEP IV: DUE DILIGENCE

A signed NDA begins the first of — assuming all goes well — many rounds of due diligence ("DD").

Put simply, due diligence is the investigation of a target's business by the potential buyer. This step involves the buyer, the seller, and if engaged, the buyer and seller's advisors.

Buyside deal teams typically start with an initial 2 to 3 week diligence round, followed by a non-binding indication of interest, and then a much deeper diligence round lasting 2 to 6 months that will precede the letter of intent.

During the multistep saga that is the diligence process, the investor will start with a review of the seller's confidential information memorandum ("CIM"). A well prepared CIM will generally include a robust overview of the:

- Business
- Operating history
- Industry dynamics
- Competitive landscape
- Barriers to entry
- Core customer base
- Go-to-market strategy
- Primary performance drivers
- Scalability
- Assets (e.g., intellectual capital, patents, facilities, etc.)
- Growth opportunities
- Management team
- High level financials (ideally five years of historicals plus five years of projections)
- Discussion of the company's ability to execute on said projections

- Summary of the auction process, the proposed structure of the deal, and expected timeline for expressions of interest (a.k.a. bids)

Next, the buyer will set up meetings with the management team alongside site visits, supplier meetings, customer interviews, and expert interviews, as appropriate.

In addition the seller, sometimes aided by sellside counsel, will usually set up a virtual data room. The seller will then upload the following types of information to this storage space:

- Specific information that potential buyers have requested; for example, a buyer considering the merits of consolidating real estate and shuttering underperforming stores might ask the target for a list of retail locations and the lease expiration date for each location
- Information that gives the buyer improved visibility but was too data heavy to include in the teaser or CIM; for example, scanned copies of the seller's seven primary supplier contracts, or perhaps original terms for its two outstanding bank loans
- Information that gives deeper insight or detail than the CIM; for example, a seller distributing organic milk products might want to break down performance by product type, flavor, fat content, size, and SKU
- Information that becomes available over the course of the deal process; for example, a seller launched the sellside process in November 2013 and posts its 2014 financials to the data room in March 2014

All else equal, the volume of information presented in the seller's data room will increase with its size, the complexity of the transaction, and the number of potential suitors involved in the process.

In most transactions, the diligence process is a two-way conversation. While the target will usually kick off DD by circulating the CIM and giving investors access to its data room, by midway through diligence buyers are often emailing the target's management team, investment bank, and legal counsel to request information. The primary goal of diligence is to provide a comprehensive picture of the target, communicate risks, answer any questions, and — possibly most importantly — present the information that will fuel the buyer's thinking around operational improvements.

Business Owners, Deal Professionals, Due Diligence, Preparing for a Transaction

generally conditional document that reflects available data, moves buyers onto a shortlist, and moves them through to the second round.

In the IOI the buyer will generally outline:

- Approximate price range for the business; this can be expressed as an absolute dollar amount (e.g., \$15 – \$20 million) or multiple of EBITDA (e.g., 3.0 – 5.0x EBITDA)
- Details on available funds (i.e., cash and equity) and debt financing sources
- Potential transaction structure (e.g., cash vs. debt ratio, leverage tranches)
- Management retention plan
- Intended role of equity owner(s) after the deal has closed
- Key items needing further diligence
- Planned diligence timeline
- Expected timeframe to close

There are four primary purposes of the IOI.

First, it allows the seller to retain higher participant quality by asking that buyers demonstrate a threshold level of commitment to advance to the next round. Second, it gives the seller color both on buyer seriousness and approximate valuation range. Third, it allows the seller to focus its time on a few players with which to have more intimate discussions. And finally, it limits the number of parties that are privy to the seller's wealth of internal company data. Indeed, one of the biggest tradeoffs of having a very broad process is that a seller, in the process of executing a deal, risks giving away its most valuable trade secrets to an audience that's larger than it needs to be.

After the buyer sends its IOI over, the seller can choose to either accept, negotiate, or deny the buyer's terms.

Inside the Leveraged Buyout Deal Process (Part II of III)

By Kateri Zhu | April 9, 2014

This article is the second installment in our three part series on the leveraged buyout ("LBO"). There are ten primary steps to executing an LBO.

This section will cover the sequence of actions that take you from the indication of interest, to the letter of intent, and to final deal negotiation.

STEP V: INDICATION OF INTEREST

After a cursory round of diligence the seller will give its potential buyers a deadline by which all interested counterparties must submit their indication of interest ("IOI").

Put simply, an IOI is a first round bid for the business. It's a non-binding,

STEP VI: LETTER OF INTENT

Assuming the seller and buyer agree on the terms of the IOI, the buyer enters the next round of bidding and begins an in-depth course of due diligence (“DD”). The aggregate time involved with diligencing a buyout target is generally between two and six months. However because of the high time and resource commitment involved, the buyer will usually negotiate and sign a letter of intent (“LOI”) with the seller after it has performed some diligence, but before it completes full DD.

By definition, the LOI is the agreement that documents, in detail, the buyer’s intention to execute the transaction and is substantively more thorough and legally declarative than the IOI. In an LBO, it outlines the investor’s plan to buyout the business and discloses the most important deal terms.

More importantly it gives the buyer exclusivity, which is effectively the right to purchase that business within a certain timeframe. It’s now common for buyers to request an exclusive negotiating period, which is meant to ensure that the seller is not shopping their deal to other bidders while appearing to negotiate in good faith. This is particularly important because buyers will frequently involve outside consultants and legal counsel to help with diligence, and as such, need assurance that it’s not throwing money at an assumed transaction while five other buyers are still in the mix.

The contract can be from two to ten pages long. It will usually include:

- Details on the format of payment, whether cash, stock, seller notes, earnouts, rollover equity, or contingent pricing
- Transaction structure specs defining the deal as a stock or asset purchase; generally speaking, asset deals protect the buyer from prior liabilities and provide a stepped-up

tax basis and stock deals benefit the seller from a tax and legal perspective

- Updated estimate of closing date
- List of tasks that need to be completed by closing
- Approvals needed by the buyer (e.g., board of director vote) or seller (e.g., permissions from regulatory agencies) to complete the deal
- Binding period of exclusivity; this is usually one of at least three

binding clauses in the contract and typically lasts between 30 and 120 days; while the duration might be negotiable, the presence of an exclusivity clause will almost always be non-negotiable

- Binding break-up fees; deals greater than \$500 million in aggregate value usually include a fee schedule that protects the buyer from an owner withdrawal; this can either be a percentage (typically 6%) of the total transaction value or a fixed dollar amount
- Binding confidentiality terms that go beyond the original NDA
- Management compensation plans detailing which current executives should be retained post-transaction, their equity plans, and their employment terms; this is often worded vaguely to give the buyer latitude since it may not be in a position to make broad commitments to executives
- Any additional areas of due diligence required by the buyer

- Depending on the deal, a summary of the buyer’s expected escrow terms; this allows it to hold back a percentage of the purchase funds to cover future calls for past seller liabilities; this is generally highly negotiable and will sometimes be excluded from the LOI, and presented for the first time in the purchase agreement

The LOI is an important milestone in the successful sale of a company. While it doesn’t guarantee a closed deal, it’s a clear signal that the buyer has serious intentions.

The LOI is an important milestone in the successful sale of a company. While it doesn’t guarantee a closed deal, it’s a clear signal that the buyer has serious intentions.

STEP VII: NEGOTIATION

The negotiation process involves two primary parties — the seller and buyer — and, depending on the deal, several additional players — the sellside advisor (i.e., investment bank), sellside legal

counsel, buyside advisor, buyside legal counsel, and buyside lenders.

The seller’s primary goals are to complete the sale, maximize its sale price, and secure a favorable buyer (meaning one that brings specialized experience to the table and / or with which it has a synergistic relationship). As a result, though its advisors are almost always involved in negotiations (more below) the seller has the final say in valuation conversations and bidder selection.

The buyer’s primary goals are to achieve a high internal rate of return (“IRR”) and a strong money multiple, the two most common measures of investment profitability. Funds are under pressure to hit a certain performance level because it (a) drives the amount of carry received upon exit,

(b) influences future management fees and (c) determines whether future funds can even be raised. The three main drivers of performance are entry price, exit price, and leverage. As a result, buyers are rightfully focused on price and leverage during the negotiation.

The final acquisition price will be a balance between intrinsic valuation, market conditions, the buyer's ability to reach its fund performance targets, seller expectations, and competition for the asset. Most LBO investors begin the valuation process (which launches months before the LOI) by identifying the maximum amount that they could pay in order to hit their return target.

The sellside advisor's primary goals are to close the deal and maximize sale price. During negotiations it will provide support, counsel, and often represent the seller in conversations with buyers.

The buyside advisor is focused on helping the buyer find the right investment, closing the deal, and building relationships to support future business. It will create internal financial models to check valuation, assign independent credit ratings to the target, and validate the target's ability to service a certain amount of debt.

The buyside lenders are the capital providers that fund the debt portion of a leveraged buyout (i.e., the revolver and term loans). Their primary goal is to put their cash into investments with a balance of decent risk and return characteristics. As a result, not only do they run their own due diligence, but also often step in to negotiate debt covenants aimed at mitigating borrower behaviors that might increase default risk.

Business Owners, Deal Professionals, Preparing for a Transaction

Inside the Leveraged Buyout Deal Process (Part III of III)

By Kateri Zhu | April 16, 2014

This article is the third and final installment in our three part series on the leveraged buyout ("LBO").

This chapter will cover the sequence of actions that take you from the actual acquisition of the business, through the management period, and to its final sale.

STEP VIII: ACQUISITION

This step launches the multi year period during which the buyer owns, manages, and helps grow the acquired business.

Every player involved in negotiating the deal — the buyer, seller, and depending on the transaction, the sellside advisor, sellside legal counsel, buyside advisor, buyside legal counsel, and buyside lenders — work together to execute the acquisition.

The financing structure is reviewed and vetted, the bookrunning bank syndicates the debt, lenders wire the funds, the new owner assumes official management of the business, and new directors — this often includes the fund partner that led the LBO and certain experts the fund believes to be value additive to the acquired business — take their seats on the Board of Directors.

STEP IX: MANAGEMENT

This phase is, by far, both the longest and often most important part of the process. It begins when the buyer purchases the company, ends when it's sold to another owner or goes public, and usually lasts three to ten years long.

This multi-year period is when the buyer — now the owner — improves the business in ways that create value. These levers are (a) earnings growth, (b) debt paydown, and (c) multiple expansion.

Earnings growth means that the business is becoming more profitable. This can be achieved by increasing the topline (i.e., organic growth), improving the bottomline (i.e., higher efficiency), or cultivating inorganic growth (e.g., acquisitions). Frequently it entails a combination of the three.

Debt paydown means that the business is increasing its equity-to-debt ratio. It accomplishes this by paying back borrowed funds and thereby reducing leverage. In other words, the company is not only generating excess cash, but using that cash to reimburse lenders that lent the capital to complete the buyout in the first place.

Multiple expansion means that the business is being sold for a higher earnings multiple than that at which it was bought (i.e., the new buyer is paying more for every dollar of earnings today than the original buyer did). The earnings multiple is usually expressed as a multiple of EBITDA (e.g., 5.5x EBITDA) and is covered in more detail in our article on why LBOs generate higher returns. Multiple expansion is typically a product of improved growth opportunities, increased company size, more efficient operations, favorable industry dynamics, or a bull (i.e., strong) market.

Before we move forward, one should note that these three types of value creation are not easy to execute. Growing the bottomline by 4% or paying down 3% of debt — perhaps — but to generate 20%+ of value every year requires a thoughtful process, a surefire blueprint, and rigorous execution.

As such, there are five general steps to methodically managing an LBO candidate.

Determining the potential. In this stage the owner defines a maximum value for the business. This process takes root throughout the first eight steps of the deal process, and is accomplished by identifying opportunities for improvement during due diligence, management meetings, external research, and internal analysis, and subsequently incorporating them into financial models.

The inputs to these models are the materials that the now-owner, formerly buyer, touches during the transaction process. As you might recall this includes public information, the company's website, the teaser, the confidential information memorandum, historical and projected financials, contracts, legal records, management meetings, interviews with customers, industry analyses, etc.

Most buyers will create three models during the deal process: a downside case, a base case, and an upside case. The latter two reflect how the business would perform if management were to successfully implement some or all of the improvements. The former will maintain a set of conservative — often very conservative — estimates.

These financial models serve as a benchmark of future potential and illustrate what can be achieved over the management period.

Creating the game plan. The game plan is a comprehensive framework for how the business can reach its performance targets.

Most buyers will create three models during the deal process: a downside case, a base case, and an upside case.

Aligning the stakeholders. The primary goal here is to harness leadership talent and put it towards activities that facilitate the greatest gains in earnings, margins, or cash output.

The principal mechanism for alignment is a reward structure that puts management and owners on the same page. The arrangement should incentivize the company's leaders to (a) embrace the game plan, (b) tackle value additive activities, and (c) shoulder otherwise burdensome tasks.

Moreover, the most effective reward structures will usually encourage leaders to be results-oriented, proactive, and

strategically nimble. The primary goal is to foster an environment that is both metrics-driven and agile, such that management is motivated to both take on efforts that drive the company in

the right direction, and adjust course when there are better tactics for achieving targets.

Laying the foundation. This is the process of sculpting the business to the game plan, and setting up necessary building blocks. It includes structural changes, matching employees to fundamental initiatives, and securing any necessary but currently unavailable resources.

During this stage, the company's performance typically accelerates and the owner will begin to track certain operating indicators and iterate on the day-to-day game plan.

Optimizing financial efficiencies. This step focuses on improving the cash efficiency of a company. It entails the thoughtful application of buyout economics to the business. Specifically the owner will concentrate on two things:

1. Improving operating income
2. Improving net working capital

Operating income, usually defined as earnings before interest and taxes ("EBIT"), is a financial metric that gauges profitability. It is a primary focal point because it's one of the core drivers of cash flow.

To improve income, owners undertake activities that optimize any financial line item above EBIT. This includes revenue, SG&A (selling, general, and administrative) costs, COGS (cost of goods sold), and other expenses.

For example, if we're dealing with a business that requires raw inputs, the owner might run a search for additional suppliers that can provide materials at a lower cost than the company's existing suppliers. It would then help the management team negotiate new contracts and phase these new partners into production. This type of activity would reduce COGS.

Improving net working capital (“NWC”) is the second component of financial discipline. NWC is essentially the amount of cash required to run the company: satisfy sales orders, pay operating expenses, and service short term debt obligations (i.e., those due within one year).

Net working capital = Current assets – Current liabilities

Current assets = Accounts receivable + Inventory + Prepaid expenses + Cash + Marketable securities

Current liabilities = Accounts payable + Accrued liabilities + Short term debt

Moreover, working capital is a use of cash. Higher working capital translates to lower liquidity. Lower working capital translates to higher liquidity.

This metric is of crucial importance because the higher the working capital, the higher the amount of cash tied up in running the day-to-day operations, and the less financially efficient the business. Capital providers are similarly focused on NWC because it gauges operating liquidity and is likewise one of the the core drivers of cash flow.

To optimize (meaning decrease) working capital, owners undertake activities that minimize current assets (“CA”) or maximize current liabilities (“CL”).

For example, an owner might implement a more proactive collections process and solicit customer payments closer to the point of sale. This would reduce accounts receivable, thereby reducing current assets, thereby reducing net working capital, and thereby increasing cash flow. Similarly, an owner might limit the company’s cash balance to the amount needed to meet day-to-day expenses, thereby lowering current assets and increasing cash flow. In addition, an owner might identify the optimal amount of inventory —

that both allows for uninterrupted customer supply and reduces the amount of cash tied up in idle inventory. This action would reduce current assets, thereby reducing net working capital, and thereby increasing free cash flow.

On the other hand, an owner might choose to optimize net working capital by increasing current liabilities. For example, it might help the leadership team negotiate its supplier contracts from cash to credit — or more plausibly — from the current credit terms to more lenient credit terms (e.g., 30 day versus 45 day payment period). This type of activity would reduce the amount of cash tied up in working capital and increase the cash flow liquidity of the business.

The best financial sponsors are those that handle the management period extremely thoughtfully and meticulously. They are able to identify both the company’s strengths and its development areas, select the right (meaning most impactful) areas for improvement, come up with a game plan, execute on this plan, optimize the financial skeleton, and change course when the hypothesis warrants editing.

STEP X: EXIT

This step marks the end of the ownership period. On average, the exit occurs five years after the original purchase of the company. It can range from between three and ten years out.

The decision to exit is almost always a difficult balancing process. The (a) current sale prospects for the company have to be weighed against (b) untapped opportunities to create future value and (c) incentives to exit before the IRR flattens*.

Why is this? Although good buyout candidates usually exhibit strong performance beyond just five or even ten years, the downward pressure on IRR increases in tandem with investment length, as returns are spread over more years.

For example, a good business can continue to generate additional cash-on-cash returns while simultaneously reducing IRR. As a result, incremental value creation opportunities usually need to be sizable in order to justify delaying an exit past a certain point.

Owners typically exit LBOs in one of four ways:

1. Strategic buyout
2. Secondary buyout (i.e., a sale to another financial sponsor)
3. Management buyout
4. Initial public offering

Strategic buyouts occur when the company is sold to a corporation, commonly referred to as a “strategic buyer” or “strategic”.

This usually happens because the corporation sees value in vertical integration or the company’s product portfolio, customers, intellectual property, patents, brand, leadership, or synergy potential.

These exits also tend to offer the highest exit value because a strategic’s synergies and lower cost of capital (a result of lower leverage and a correspondingly higher credit rating) will be factored into the dollar sum that it’s willing to pay to purchase the business.

Secondary buyouts occur when the company is sold to another financial sponsor.

This usually requires a high degree of leverage and a favorable cost of capital, because the new buyer needs to be able to achieve high returns a second time around with the same business.

Consequently, secondary buyouts are often an outcome of the original buyer electing to exit within a certain timeframe in order to maintain a high IRR, and therefore occur predominantly with high performing businesses.

Additionally, these exits typically come with less of a premium than a strategic buyout, given the absence of cost or revenue synergies and the generally more restrictive sponsor debt terms.

Management buyouts (“MBOs”) occur when the existing management team purchases the business back from the current owner.

This type of exit occurs in a very specific scenario: when the financial sponsor wants to exit, members of the management team wish to make the transition from employees to owners, and there are no competitive bids from other buyers.

MBOs typically require a substantive amount of external financing and will usually entail a combination of equity and debt funding from the management team, third party capital providers, and sometimes the seller.

Initial public offerings (“IPOs”) occur when the owner decides to sell his stake in the public markets rather than to a private buyer (e.g., another sponsor or a strategic).

This involves going through the process of making the company a publicly traded entity but, depending on the markets, may result in a lower or higher value than a strategic or secondary buyout. Moreover, IPOs almost always offer only a partial exit to the owner, with the complete exit coming in subsequent secondary offerings.

*In certain highly successful leveraged buyouts, the decision to exit is weighed against the time at which IRR drops to a certain threshold rather than when it flattens. For example, if a company is generating 70% IRR over the first two years, an investor will most likely choose to retain the investment even if the IRR will almost certainly decline over the next several years. This illustrates the balancing act between

achieving substantive cash-on-cash returns and maintaining a high IRR.

Business Owners, Deal Professionals, Preparing for a Transaction

How Private Equity Screens for LBO Candidates

By Kateri Zhu | May 28, 2014

The leveraged buyout (“LBO”) has become well-practiced among private equity professionals, and is now standard industry practice as a means by which to acquire private companies.

Yet it can be used by any capital provider with the experience, credibility and business to secure the confidence from the financing sources required to execute an LBO.

The LBO gained prominence in the 1980's thanks to Jerome Kohlberg and his associate, Henry Kravis. These two joined forces with the latter's cousin, George Roberts, to conceive what would become a private equity triumvirate with the birth of their firm, KKR. Today over 2,800 private equity firms exist in the US alone, buying thousands of companies each year.

As its name implies, the use of financial leverage, or debt, is one of the primary elements that distinguish an LBO from a traditional acquisition executed with cash or stock. Leverage can enhance equity returns to the sponsors, who have discretionary control over all cash flows that exceed the debt payments incurred. Because interest payments on debt are tax-free, leverage improves equity returns by reducing the amount

of equity required to acquire a company, and then further magnifies those returns through the favorable tax treatment that interest payments receive under US tax code.

Not every company is a viable LBO candidate, however.

Detailed below are a set of characteristics that deal professionals typically seek when assessing a target company's viability for an LBO-style change of control transaction.

HARD ASSETS

Banks lend more cheaply against hard assets as collateral. If your assets consist predominantly of your employees, it can be very challenging to gain bank financing. Bank debt is usually collateralized by the physical assets of the company, so the more plentiful, sizable, valuable, and stable the assets – machinery, inventory, receivables, real estate – the more available and cheap the leverage for your deal becomes. While these hard assets certainly help the credit structure, intangibles like brand names, goodwill, and human capital have nonetheless become increasingly important considerations in an LBO.

STEADY CASH FLOWS

Free cash flow is king in an LBO, and it's generally defined as the amount of cash that a business generates in excess of what's required to maintain its current operations. The reason this is so critical is because the free cash flow of a company's operations determines how much leverage that company is capable of supporting without imperiling its ability to stay solvent in a downturn.

MATURITY OF MARKET

Companies selling into an established, well-defined market (e.g., automotive valves, soft drinks, etc.) are more conducive to an LBO than those selling into a fledgling market (e.g., social networks, nanotech, etc.). Indeed

while an entity's growth prospects are important, they are secondary to stability. A mature market with predictable demand, steady revenue, and no eminent game-changing competitor-crushing disruptions is ideal for a buyout because the cash flows of the company are likely to be substantively more predictable.

LOW CAPITAL EXPENDITURE REQUIREMENTS

The lower the annual investment required to operate a business, the better. Consistently high levels of capital expenditure are unwelcome, as they consume cash that could otherwise go toward paying interest payments, principal debt payments, or dividends to the equity holders.

NON-CORE ASSETS

There are few ways to boost cash flow more painlessly than to liquidate non-vital assets that carry an attractive value to the right bidder. If a publisher derives the majority of its topline from digital media but maintains a costly and unprofitable printing press, it can sell the latter for cash. An experienced financial sponsor keen on leaning out of a business often spots this kind of low-hanging fruit quickly, and might move to sell anything of value that's not functionally synergistic with the core business.

FORCED DIVESTITURES

Regulators from time-to-time mandate corporate spin-offs for antitrust reasons. For instance, if two coal companies merging would cause their combined revenue or market share to eclipse acceptable antitrust thresholds, the approval of the merger would be contingent upon spinning off certain mines to a third party. The regulatory divestiture typically presents a buyer with a good deal, as the sale process is typically extremely hurried so as not to delay the proposed merger.

NON-CORE CORPORATE DIVISIONS

Sometimes some of the subsidiaries or divisions of large conglomerates no longer make sense or fit in with the future of the company's plans. In these instances companies will "spin off" these less relevant divisions, realize the cash, and reinvest it in accordance with the new strategic directives of the organization. In October 2011 for example, Smith & Wesson announced that it was spinning off its security division to concentrate on its more profitable firearms business.

BUSINESSES WITH SUB-PAR MANAGEMENT

The most successful private equiteers often possess high degrees of specialization, and for that reason, can add tremendous value to the organizations that they acquire. It's meaningfully more easy for savvy industry veterans to spot solid businesses that are underperforming as a consequence of poor management. Such a business is an attractive LBO candidate to a buyer that is confident in its ability to more efficiently operate the company and survive the debt burden.

BUSINESSES LACKING A SUCCESSION PLAN

This qualifier is especially pertinent today as baby boomers retire in the United States and leave healthy businesses lacking heirs. Private equity firms typically love these companies as they present opportunities to acquire a high quality business that needs minimal help, but comes with an owner that simply wishes to cash out.

BUSINESSES IMPAIRED BY UNDERLYING INDUSTRY

Sometimes businesses with attractive long-term earnings capacity are held hostage by a poor underlying industry or economy, causing deflated trading prices and valuations. Such opportunities are attractive, offering a chance to buy companies for cheap before an expected rebound in the market price.

Bottom line: understanding how private equity firms screen for and think about LBO feasibility is exceptionally beneficial to advisors evaluating which assignments to take on, entrepreneurs thinking about who to sell to, management teams considering an MBO, and corporations evaluating which buyers will be interested in purchasing their non-core divisions.

Business Owners, Preparing for a Transaction, Sourcing Deals, Transaction Process



What Do 89% of CEOs Do Before Talking to You?

By Billy Fink | October 8, 2014

In a survey of 769 business professionals who run, advise, or invest in private businesses, we asked how digital tools are being used in the transactional space and about the opportunities that they present.

In the changing deal environment, a few things are clear: the web is now the first part of the deal process, professionals are seeking digital information and connections, and the online world is heating up competition for the best deals.

Below are 3 important trends that emerged from the results:

YOU MUST BE ONLINE

Unsurprisingly, the first step for deal professionals when being introduced to someone new is to go online. In fact, in a world where the handshake is often the final step, 92% of business professionals start relationships by going online – both looking up the person and looking up the firm.

Refer to Graph A.

As it turns out, only 6% of the respondents indicated they would first ask a mutual contact about a potential business partner.

For CEOs, 89% go online for the first step. Googling a person's name or going straight to a company's website is the point of first touch when it comes to researching a potential financial or business partner (36% and 35% respectively). Sixteen percent of

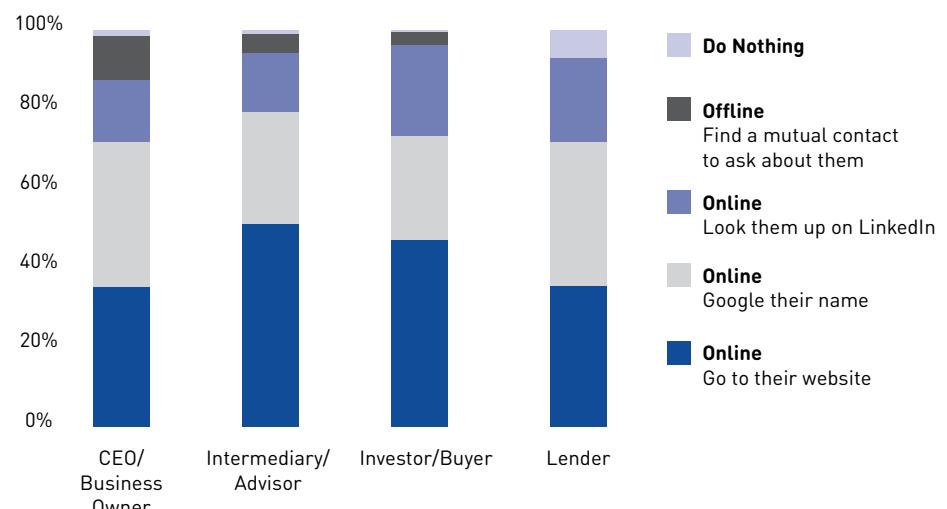
Graph A.

FIRST STEP FOR A NEW CONTACT



Graph B.

FIRST STEP FOR A NEW CONTACT



CEOs go to LinkedIn first and only 11% find a mutual contact to ask about the person in question.

Deal professionals say they will go to a company's website (48%), before they use Google to search a name (27%) or go to LinkedIn (18%). Very few (4%) deal professionals turn to a mutual contact prior to first touch. Interestingly, professional networks like LinkedIn are more popular with capital providers — lenders, investors and acquirers (23%), versus intermediaries — advisors and bankers (15%).

[Refer to Graph B.](#)

The prevalence of online communication and outreach helps confirm that deal professionals need to invest in both inbound and outbound online business development channels to best capture interest from all relevant counterparties.

VARIED USE FOR ONLINE TOOLS

While the data confirms that an overwhelming number of deal professionals and CEOs engage with online tools and social media, the specific strategies vary. Across the board, respondents agree that online tools can best aid any part of their job that requires research and evaluating information. Thirty-nine percent of all respondents, 41% of deal professionals and 27% of CEOs say so. Within the deal professional category, it's the capital providers who believe they can unlock networking advantages by using online and social tools (37% vs. 26% of intermediaries). Twenty-six percent of intermediaries also say marketing is the number one opportunity.

[Refer to Graph C.](#)

The results also point out a disconnect between CEOs and the transaction professionals that serve them in how they believe online tools and social media can power their networking goals. 32% of deal professionals say networking with partners and

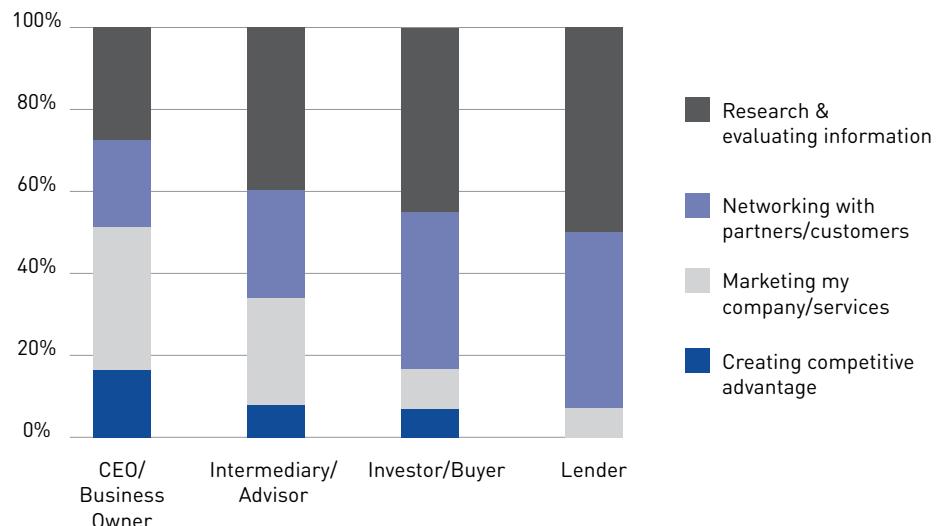
Graph C.

PRIMARY ONLINE STRATEGY (%)



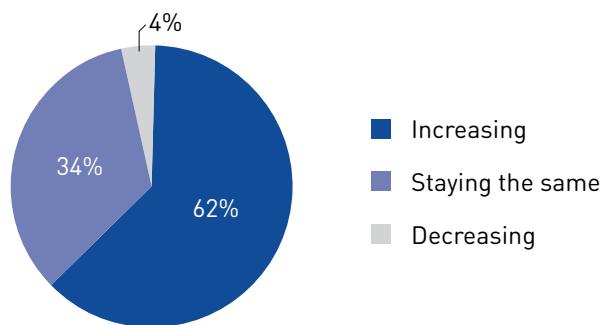
Graph D.

PRIMARY ONLINE STRATEGY (%)



Graph E.

CHANGING COMPETITION (%)



customers is the single biggest opportunity that online channels provide. Meanwhile, CEOs are more bullish on using online channels to market their company's product and services (34%). Twenty-one percent agree that networking is the number one opportunity that technology and social media represent.

[Refer to Graph D.](#)

COMPETITION IS INCREASING

The use of online strategies and tools has accelerated the competition within the private capital markets. No longer confined to specific geographies or personal networks, deal professionals and business owners can now reach counterparties all across the country. As a result, an overwhelming 62% of respondents indicated that competition was increasing for their respective businesses. Only 4% indicated it was decreasing.

[Refer to Graph E.](#)

As competition increases, it is critical to be discoverable online. The above research proves that deal professionals and business owners alike are utilizing online tools and strategies to help find the right partners. If you do not have a developed presence, your ability to compete in today's private capital markets are slim to none.

A Note on Methodology

Respondents included Axial Concord attendees and subscribers to the Axial's online publication, Forum. All respondents self-identified as either a business owner/CEO, investor/buyer, lender, intermediary/advisor or other type of deal professional. Results were collected between September 30 and October 5, 2014. Surveys were distributed in person and also via email.

Client Acquisition, Data & Analysis, Deal Professionals, Preparing for a Transaction

Does It Matter That KKR Joined Twitter?

By Cody Boyte | May 1, 2014

This year, KKR, a titan of private equity joined the social media fray with their first ever tweet. It commemorates their 38th anniversary. Though Carlyle and Blackstone have been on Twitter since 2011 and 2012 respectively, KKR apparently needed to do deeper due diligence on the benefits of the platform.

If Carlyle, Blackstone and KKR are all active in social media, should everyone be active? Likely – but probably for different reasons.

For the public giants, like KKR, the benefit of social media is as another channel of communication and helping their investors understand the firm's stance on different issues. It's not entirely separate from investor relations. With thousands of shareholders, and a much broader audience with which to engage, having multiple channels of mass communication is valuable — especially if your competitors are better at it. At the time of writing, KKR's 364 Twitter followers pales in comparison to Carlyle's 6,217 or Blackstone's 27,400+.

The benefit is slightly different for smaller, private shops. Middle market private equity has other challenges, usually more associated with deal

sourcing than fundraising or IR. Social media can help become a point of differentiation and branding, driving real business results. One of the primary problems for private equity historically has been the 'private' nature of their business. PE groups often try to stay out of the spotlight, resulting in few business owners understanding why they exist or why they should be trusted.

But that's probably not the best strategy going forward for most private equity groups. Using social media well can help answer the questions CEOs have about your business. Why are you the best buyer or financier for a company? How will you treat their employees? What strategies do you tend to employ? How do you think about running a business? What does your company really care about?

Competition in traditional private equity has started to look more and more like venture capital the last few years. With

If Carlyle, Blackstone and KKR are all active in social media, should everyone be active? Likely – but probably for different reasons.

so much money floating around, access to capital is no longer a major problem for quality companies. For the most part, every private equity group is looking for similar criteria – solid, growing businesses that can scale with good management teams.

Like good startups, great middle market companies also usually have the upper hand in choosing the private equity group that will buy or fund them.

Venture capitalists tend to be a little bit ahead of the curve because they have to be – the business is cutthroat, returns are unpredictable and only the best generate positive returns. A decade ago, few VCs were well known publicly. Today, Brad Feld, Fred Wilson, Mark Suster, Tomasz

Tunguz and others are finding that engaging in social media helps them communicate their ideas to prospective CEOs more readily. It helps them win better deals because great companies connect with their ideas and approach them first for investment.

As David Hornik – the first venture capitalist to begin blogging over a decade ago – wrote, “blogging has become an incredible megaphone. Over the years, millions of people have read what I have to say about venture capital and entrepreneurship.” He continued, “In combination with the powerful amplification of social platforms like Facebook and Twitter, VentureBlog has proven a valuable tool for me and my firm to rise above the noise.”

Many middle market CEOs are engaging in social media regularly as well. They’re using it to read the news, connect with employees and market their businesses. But they’re also using it to connect with thought leaders. They’re reading articles by potential partners, capital providers and future acquirers. Are you part of their conversation?

Just as investors prefer investing in lines not dots, CEOs prefer to really know their partners before engaging in a transaction. Learning how to become a part of deeper conversations with a wider range of business owners before they’re interested in doing a transaction can give you a leg up when it comes time to work together. Social media is where many of the discussions happen – both on Twitter and LinkedIn. Differentiation happens one tweet and connection at a time.

Deal Professionals, Future of Capital Markets,
Sourcing Deals

Social Media: An Overlooked Business Development Tool

By John Grimley | JG | Communications
September 3, 2014

Mid-market deal professionals, from private equity professionals to investment bankers, often face the challenge of being perceived as simply a vendor to mid-market C-Suite executives – their services indistinguishable from their competitors.

However, social media is increasingly becoming a tool to help overcome this misconception. Kevin O’Keefe, CEO of Seattle-based LexBlog Inc., a social media solutions provider to the legal services sector, outlines in a blog post how attorney David Sussman is using social media to distinguish himself among his peers as a “value generator.”

O’Keefe cited Sussman: “We are reminded constantly that without value, we have no chance for business continuity. CEOs and ‘C’ level executives want to be engaged and I refuse to be considered a ‘vendor’ to our client-partners.” O’Keefe continued: “Sussman shared with his associates how using social media for less than a year has built his credibility and reputation.”

SOME MID-MARKET PROFESSIONALS ARE ALREADY ACTIVE ON SOCIAL MEDIA

Sussman, however, is not the only deal professional and advisor using social media. This type of engagement is taking place already in the middle market – but it’s the exception rather than the rule. Some forward thinking middle market advisors are actively engaged on a variety of social media platforms where they are attracting needle-in-the-haystack deals that non-social media engaged advisors won’t be.

Some forward thinking middle market advisors are actively engaged on a variety of social media platforms where they are attracting needle-in-the-haystack deals that non-social media engaged advisors won’t be.

Many of these social-focused advisors are relying on their blogging as a source of activity for their business-oriented social media engagement. For example, mid-market advisors are using the content they create on blogs to actively engage online with C-suite executives and referral sources both nationally and internationally – thereby expanding their sources of deal flow from sources they might not be exposed to were it not for this considered online presence.

Among those investment banking firms that are already blogging are Allegiance Capital Corporation of Dallas, Texas, and Corporate Finance Associates of Laguna Hills, California. Among

private equity groups, New York's Health Point Capital actively blogs. And international law firm McKenna, Long & Aldridge LLP maintains Middle Market Money Blog, which provides "insight and guidance into legislation, regulation and trends to assist entrepreneurs and emerging growth companies address corporate finance and regulatory hurdles".

SOCIAL MEDIA USAGE BY THE C-SUITE EXPANDING RAPIDLY

These advisors have already recognized a very important trend: the use of social media by those who are the consumers of middle market corporate advisory services are expanding rapidly.

"Social media is emerging from its adolescent phase and is rapidly maturing", reports social media analyst and advisor Jeff Bullas. Indeed, "In 2010, the Fortune 100 were participating on social media but not to the extent they are now. The social networks were used for broadcasting but there was limited engagement. [Recently, companies] are having constant conversations with their customers and followers and creating vast amounts of digital content, reports Bullas.

Search Engine Journal provides a detailed infographic reflecting a "steep curve of the user growth rate in all age ranges and demographics, and the continuing pervasiveness of social networking into every facet of work, play and life in general."

As these middle market executives and decision makers begin seeking knowledge through common social networks, the deal professionals with an already-established presence will reap significantly larger benefits than their slow-to-adopt competitors.

WHO'LL BE NEXT?

Mid-market advisors are increasingly turning to highly efficient social media channels like blogs to reach targeted audiences. Social media is cost and time efficient, and allows busy mid-market professionals to secure more deal flow in less time and with less expense than traditional networking.

Importantly, mid-market advisors can customize their efforts with their own unique service offer and ideal potential client base in mind. For example, you are able to share industry-specific articles or highlight successes of your portfolio companies. For those mid-market advisors not yet fully engaged on social media, the adoption process is quite simple and there are many advisors already engaged on social media that are well worth emulating.

Client Acquisition, Deal Professionals, Dealmaker Outlook, Sourcing Deals

How to Secure the Best Talent for Your Firm

By *Vik Ashok | SpareHire October 30, 2014*

The M&A world is often characterized as having high employee churn and as a result, very high human resource costs. Improving your HR process is a sure-fire way to gain efficiency, cut costs, and ultimately run a more profitable enterprise.

How have PE Firms and Investment Banks Historically Sourced Talent?

Most PE shops and investment banks have traditionally relied on two main talent acquisition channels for experienced hires:

| CHANNEL | PROS | CONS |
|--------------------------|---|--|
| Personal networks | <ul style="list-style-type: none">• Reference leads to high degree of comfort• No cost | <ul style="list-style-type: none">• Small pool of talent |
| Recruitment Firms | <ul style="list-style-type: none">• Targeted search• Initial vetting handled by recruiter• Interview logistics handled by recruiter | <ul style="list-style-type: none">• Small pool of talent• Expensive (25-30% of first-year compensation)• Inflexible (heavy emphasis on full-time placements) |

These strategies left many lower middle market firms unable to find top-tier talent because they could not afford expensive placement firm fees and could not match compensation offered by larger firms. To make matters worse, a growing startup scene in the US has created intense competition for talent, with many financial services professionals leaving the industry to work at startups or start their own companies.

However, a new recruitment option that solves some of the challenges associated with existing channels is rapidly gaining traction: web-based hiring platforms.

TECHNOLOGY IS SUPERCHARGING RECRUITMENT AND REMOTE WORK

The proliferation of social networking already has made the professional world more interconnected than ever before. LinkedIn has created the concept of a publicly viewable resume and is now a major force in online recruitment, with 130,000 jobs posted per month (as of 2012). In Q2 2014, LinkedIn generated \$360M of revenue from Talent Solutions (recruitment-related activities) – 60% of its revenue for the quarter. More traditional job websites such as Monster.com and TheLadders.com allow you to access large groups of talent in an instant. These technology platforms vastly increase the pool of available candidates vis-a-vis traditional recruitment channels such as personal networks or headhunters.

Remote work has also significantly expanded the pool of available talent. Thanks to ubiquitous high-speed internet, video conferencing (Skype), and robust file sharing mechanisms (DropBox, Google Docs), managing remote workers has never been easier. With people now using technology to work together through virtual offices all over the world, the way we do business has fundamentally changed.

TECH-ENABLED JOB MARKETPLACES LOWER THE STAKES FOR HIRING DECISIONS

Thanks to the proliferation of tech-enabled job marketplaces and remote work, access to new talent is at an all-time high. This is especially important for lower middle market firms, which are now able to access a rapidly growing pool of freelance talent.

The combined effect of freelancing and tech-enabled hiring platforms means that you no longer need to commit to a full-time hire upfront. Through services like SpareHire, you can hire employees remotely and on a part-time basis to meet your work demands. Additionally, you can test run a potential employee with a real project, rather than theoretical case studies in an interview. For example, by having the potential employee build a financial model for a live deal, you can examine real work product and gain valuable insight into the employee's work style and personality before committing to a full-time hiring decision. This is a particularly valuable option if you are a VP-level or senior-level professional at a resource-constrained lower middle market shop, where your time is far better spent on deal sourcing, structuring, financing and other value-add activities.

Since the stakes on both sides are generally lower for projects than full-time hires, freelance projects offer the added bonus of enabling you to tap into higher caliber talent than you otherwise could have. An ex-Goldman banker may be working on a startup of his own and be willing to help with a model or investor presentation, but is unlikely to join a boutique M&A shop on a full-time basis due to the opportunity cost. Freelance projects offer a viable way for you to access this top-tier talent.

SO WHAT?

Thanks to the strong network effects of the internet, accessing high-caliber talent on demand has never been easier. Remote work is quickly becoming a major component of our economy. As information flow and liquidity continue to increase, technology should significantly reduce

the cost of finding talent. If you run a small M&A shop, make sure you are taking full advantage of the internet to manage your HR efforts.

Client Acquisition, Deal Professionals, Sourcing Deals

Survey Says: Business Owners Use Technology to Find Capital

By **Billy Fink** | August 20, 2014

To better understand the mindset of today's private company executive, we collaborated with the Financial Executives Networking Group (FENG) to survey financial executives in the United States about their needs and uses for capital. The 250+ responses have offered some unique insights into how these decision makers are thinking about the private capital markets and about growing their businesses.

Three major themes emerged:

#1: THERE IS A NEED FOR CAPITAL

One of the biggest takeaways from the survey is the overwhelming need for capital. Sixty-nine percent of the respondents indicated that they would be looking for capital in the next 12 months. These capital seekers were particularly concerned about obtaining "enough" capital — either from existing sources or from new sources.

If the financial executives were to secure their desired amount of capital, they would allocate the money to

a variety of purposes: operations, expansion into current markets, repaying new investors or lenders, acquiring new business, and R&D. Working capital needs and expansion (both in current and new markets) seem to be the clearest pain points for the respondents.

#2: BUYING AND/OR SELLING

When it comes to larger transactions — like buying or selling a business — the conversations have been a little different for these financial executives.

On the acquisition front, 51% of respondents talk openly about acquiring new businesses or expanding in new markets. When asked if they would acquire a competitor, an overwhelming 77% said they would if the conditions were right.

Significantly fewer business owners talk openly about selling their own business. According to respondents, only 29% have had an open discussion among chief stakeholders about the idea of selling the business to a new owner.

As M&A activity in the middle market continues to heat up, it is prudent for many CXOs to begin having these conversations in order to be prepared to respond to increasingly proactive outreach from investment bankers and other advisors. In fact, 45% of respondents indicated they have heard from more investment bankers this year than the year before. In order to avoid wasted opportunities, financial decision makers should begin internal conversations about the opportunities for their company so they are ready when the right relationship or deal comes their way.

The respondents also indicated that, if they were to sell their business, the current price of the business would be the single most important factor when considering the transaction. Second would be other financial considerations, like guarantees or earn outs.

#3: TECHNOLOGY IS IMPACTING RELATIONSHIP BUILDING

When business owners decide they do want to tap the private capital markets (and 67% said they will in the coming months), there is an indication that they are expanding their relationships with technology and the internet. Of those that have used technology, 60% have indicated that software and internet tools have made the process of identifying relevant options and opportunities easier. This is a trend we are seeing as more and more business owners look to the internet to learn more about the private capital markets.

Business Owners, Data & Analysis, Preparing for a Transaction



9 Things Every Business Owner Needs to Know Before Selling

By Mason Myers | Greybull Stewardship August 21, 2014

When selling your business, it pays to learn lessons from others. Most business owners will not get a second chance to do it well, and it is such an important process for your employees, your customers, and your own bank account that you want to maximize your chances of success.

I have been involved in over 30 business purchases – most with between \$1 million and \$5 million in profit — and have earned scars from broken deals, learned many humbling lessons, and burned the midnight oil doing my best to craft the perfect win-win arrangement. Even now, I learn something new or experience something unpredictable in each transaction.

Here is the best of what I have learned:

1) PUT TIME ON YOUR SIDE

Most business endeavors are easier and better when time is your friend. The opposite is also true — it is difficult to optimize the results of a business sale if you compress the time available to work all of the components. This applies to both the time available each week and the time from the start to the finish of the overall process.

It is wise to begin thinking about selling your business well before you want to or need to. Sometimes it takes years to craft the best trends in your business, get proper accounting processes in place, get the management team in place, and find the best investment banker. I recommend that owners anticipate

that the sale process could be a half-to full-time job by itself and they are well served by setting up an internal management structure that can keep the business on track during the months of a sale process and getting outside help (see below) to help manage the process.

2) GET EXPERT ASSISTANCE

You will come out ahead, both financially and psychologically, when you hire an adviser to help with the process. The payoff will come on multiple fronts. First, they save you tremendous time in talking with buyers, preparing documents, and providing a buffer to allow your business to stay on track during the sale process. Second, they have experience navigating the sometimes confusing waters of a sale process. Third, they can broaden the net of potential buyers, which is very important to maximizing the highest probability and highest valuation of a sale. Networks like Axial will also help you widen your net.

3) ORDERLINESS IS GODLINESS

Appearances matter in the sale of your business. It is surprising how much the appearance of your records, reports,

files and processes can impact how potential buyers view your business. I think this is because every impression is important as buyers are operating with very little information so every little thing leaves an impression. Being organized conveys to buyers that this is a well-managed business. And, it will save you tremendous time to be orderly and organized when it comes time to produce documents and many other things for the buyer, particularly during due diligence.

4) GAAP ACCOUNTING

Make sure you speak the language of business, banks, and investment professionals. For some business owners, selling a business is like entering a foreign land where the primary language is GAAP and EBITDA. To operate effectively in this foreign land, you need to understand the basics of GAAP (Generally Accepted Accounting Principles). I have had business owners tell me that “cash is all that matters”, or that “I have my own way of accounting that works for us”. That is fine, but investors will not understand your particular language very well. Therefore, you need to make sure that your financial statements are presented using GAAP

and it is often worth it to hire a firm to do a review, an audit, or a Quality of Earnings analysis to get your company prepared and ready.

The number one pitfall can be situations where the business receives cash before delivering the product or service. To business owners, they often consider that cash to be revenue. In GAAP, that is not revenue until the product or service is delivered, and this can make the company's revenue appear dramatically different. There is nothing that hurts your credibility more than financial results that are significantly different when prepared via GAAP — it just makes you look unprofessional and naive.

5) GETTING KEY CONTRACTS AND LEASES ASSIGNED TO THE BUYER

A wise investment banker once told me, "no one is more arrogant than a landlord in a tight market." That is true, and unbelievably frustrating when a landlord is holding up the sale of your company. Most stopgaps occur because the landlord will not assign the lease to the new owner or he is using this point of leverage to extract some economic concessions from you or the buyer. I recommend that you begin to review your key contracts and leases years in advance of the sale and attempt to get them "assignable" at your option to avoid being "held up" by a landlord or key customer. This happens all the time. Right now, I have one acquisition being held up by landlords trying to extract value for assigning the lease to the new buyer. And, I have another acquisition that has been held up for 3 months while a few large Fortune 500 companies are reviewing some key customer contract assignments. It is not good to have your big sale held up by these factors.

6) MONOGAMY HAPPENS AT DIFFERENT POINTS FOR THE BUYER AND THE SELLER

In the balance of power, the seller is usually most attractive during the early part of the process since there are multiple buyers considering just one purchase. However, once the seller selects a buyer and signs a Letter of Intent, the seller becomes monogamous and loses some of that advantage. It is important for sellers to understand that there is still much that can distract or dissuade the buyer from that point forward. The due diligence better check out. And, the buyer could easily get distracted with other deals, or other companies in their portfolio, or their cousin Vinny who loses the family fortune. The seller is wise to keep wooing the buyer all the way until the closing.

To ensure a successful close, business owners should keep the underlying business performing (frankly, it is really good if the business results keep getting better during the sale process), keep impressing the buyer with various elements of the business, and understand that the buyer is not married to the deal until the check clears the bank.

7) A DEAL IS ALL ABOUT FIT AND TIMING

Along with everything else, selling a business is a numbers game. You need to find a way to maximize your chances

that you will find several buyers for whom your business is a great fit and the timing is perfect. For many buyers who may be great for your business, it may be bad timing as they are focused on raising money for their fund, or one of their portfolio companies just became distressed, or the partners are fighting. There are so many things behind the scenes that affect how buyers behave that you will never know what is truly happening in their minds. The best strategy is to cast a wide net, determine who is interested, and do not waste time with any other buyers (even when you think to yourself, "they would be perfect!").

8) EVERYONE FREAKS OUT SOMETIME DURING THE PROCESS

In nearly every purchase and sale I have seen, there has been a moment when the business owner has freaked out. This is quite normal and usually a good thing (better to have seller's remorse before the deal happens) as it allows everyone to step back out of the details and make sure the deal is really a good thing

for all involved. It is such a grueling and emotionally charged process for many owners that there is quite often a moment when they question the transaction.

When you do freak out, please don't call the buyer names. Just this week, I had a seller call me all the names in the book because they misunderstood something only to realize it was their error. It is no one person's fault that the process is frustrating and time-consuming. Most everyone is trying their very best to do the right thing.

9) CONTROL THE LAWYERS

One business owner called the process the “tyranny of the experts.” When you have not sold many businesses, it often feels safe to rely heavily on lawyers, bankers, accountants, and others from the expert universe. This is important to a point. It is also important to not let them drive the process too much. You are the decision-maker. You have good business judgment. If you have questions, ask them. Ultimately, however, you will need to make the business decisions about how to do the deal (is the lawyer trying to impress you or helping you get a deal?). There always comes a moment where everyone must tell his or her attorneys to back down and get the deal done.

Business Owners, Preparing for a Transaction

concerns too often receive insufficient consideration. While IT due diligence rarely uncovers information that kills a deal, it has the potential to save the acquiring company thousands of dollars during the transaction.

This article will explore the top nine reasons to conduct IT due diligence when acquiring a company.

1) BE SURE THE TECHNOLOGY IS REAL

A financial or legal expert simply can't tell if a target company's product is real. You can't rely on a PowerPoint presentation or even a product demo to confirm authenticity — it's too easy to create something that looks great but doesn't do what it's expected to do. Ideally you should have an expert in the target company's specific technology and industry review source code, product plans, etc. At a bare minimum, you need to have a technical person sit in on a demo and ask questions. If a technology expert from the acquiring company or investor isn't available, consultants can be hired for this purpose.

2) DETERMINE THE TECHNOLOGY'S COMPATIBILITY

Even if the technology is real, you need to know if it's compatible with the acquiring company's technology. If the target company uses leading edge or proprietary technology, it may not integrate easily, if at all, with the acquiring company's legacy systems. This can have serious ramifications for the integration of the companies, the maintainability of the software and the retention of key employees at the target company.

Even in an acquisition where the target's main product or services isn't completely focused on technology, it's valuable to understand the platforms used for business services such as email and CRM. After the deal closes, integrating or migrating these services may require significant resources, and it's best to understand what will be required as soon as possible.

3) VERIFY THAT THE TECHNOLOGY CAN BE SUPPORTED

This broad area includes basic things, such as whether or not the target company has a clean copy of the source code for their technology, or whether they own the rights in the first place. These issues come up more often than you might think. Even if there is a viable copy of software source code and all ownership rights are in order, are the people who wrote the software still employed by the target company? Don't expect any of this information to be volunteered — you have to look for it and you can't make any assumptions.

4) UNCOVER LICENSING RISKS

It's not uncommon to find that a startup or small technology company has not properly licensed all of its production or development software. It's not always intentional — in the frenzy of getting a product developed and into the market, any number of administrative tasks can fall by the wayside. Whatever the reason, at some point the fact that additional licensing costs are due will come to light. You want it to be before the transaction closes, not after closing or the expiration of any holdback period for reps and warranties.

5) ESTABLISH THE TECHNOLOGY'S SCALABILITY

If you determine that the target company is real and is generally compatible with the acquiring company's technology, it is important to also consider the scalability of the technology. How will the software or systems behave if the number of customers doubles, or increases tenfold? Will the technology expand gracefully with a low marginal cost, or will significant growth require a large investment in new servers or other hardware? In the worst-case scenario,

Why IT Due Diligence Should Be a Critical Part of Every Deal

Jim Hoffman | Besler Consulting July 15, 2014

In too many M&A transactions, even those related to software and technology companies, IT due diligence is, at best, an afterthought. I've even been involved in deals valued in the high eight figures where IT due diligence accounted for, maybe, 1-2% of the overall due diligence effort.

There is no doubt that financial and legal due diligence are critical, but IT

a complete re-architecture of the technology may be required. Even if this doesn't kill the deal, it represents a significant cost that needs to be uncovered and included in the terms of the transaction.

6) IDENTIFY THE KEY EMPLOYEES ASSOCIATED WITH THE TECHNOLOGY

IT due diligence includes interviews with some or all of the target company's technology staff. Through these interviews, you can get a good feel for the personalities involved. Will they work well in a larger organization, if that describes the acquiring company? If these are important employees, you may need to put employment agreements or retention bonuses in place to be sure the key players remain post-transaction. Incorporating these plans into the initial agreement can ensure that the necessary employees are motivated to stay and keep the technology sustained.

7) DETERMINE THE APPROPRIATENESS OF CURRENT LEVELS OF RESOURCES

Many smaller companies scrape by with minimal resources when it comes to things like networking and other IT infrastructure. Has the target company put off making needed investments in order to artificially inflate profitability? If the systems are noticeably outdated, you could be walking into a large front-end investment that should be included in the sale price. Are you confident that your legal or financial experts would notice?

8) IDENTIFY OPPORTUNITIES FOR COST SAVINGS

By the same token, technical knowledge is needed when it comes to determining a realistic level of synergies in the transaction. Don't assume that simply because both the acquiring and target companies have data centers, you'll be able to

combine them after the deal occurs. Are you sure the technical platforms are compatible? Can you evaluate the skill sets of the target company's IT staff to determine if there is any overlap with the acquiring company's staff? Confirming the synergies can help avoid sunk costs and maximize the benefits from the transaction.

9) DISCOVER HIDDEN GEMS

It's not unheard of for the technology staff at a company to be working on projects that the senior management of the company isn't aware of. These experimental projects aren't likely to end up in the target company's CEO's PowerPoint of company products. The right technical expert can make the connections between these "secret projects" and the strategy and technology of the acquiring company. These projects are often uncovered during the employee interviews of IT diligence.

These are just some of the most important reasons to conduct an effective IT due diligence effort. Having a technology expert on the due diligence team is the best solution, but when that's not possible, the IT Due Diligence Guide can go a long way towards increasing your appreciation of the IT concerns involved in your transaction.

Deal Professionals, Dealmaker Outlook, Due Diligence

3 Things to Remember Before Signing an NDA

Billy Fink | June 12, 2014

NDAs have become so commonplace in middle market transactions that many deal professionals have begun overlooking their importance.

Despite their prevalence, NDAs are a tricky thing. The idea of "confidentiality" changes for each firm and for each business.

To help demystify this ambiguous document, we recently gathered several financial sponsors, intermediaries, and business owners to discuss their respective opinions on the NDA, common roadblocks, and negotiation tactics.

YOUR NDA IS A MARKETING PROCESS

While technically a legal document, the NDA should be considered a marketing tool. "The NDA typically serves as the first point of interaction between an investor and the company," one attendee explained. "You want to make this first step as easy as possible."

The NDA is a temperature gauge for what the rest of the negotiation process will be like; if the two parties cannot agree on an NDA, they will be unlikely to align on terms for the much longer, more complicated agreements further in the process. Like any marketing interaction, you want to think of the counterparty and preserve your company's brand.

If the negotiation process becomes too difficult, it can be a major red flag. Lee Miklovic of Opus Capital Partners previously told us, "We will not move past the first stage of a deal if the banker or broker is not willing to accept changes to an NDA that is otherwise one-sided and not market-based." Miklovic admitted to passing on as many as 25% of investment opportunities because of poorly-constructed NDAs or NDA-related negotiations.

Since the NDA is the first official encounter, it is important to treat it as such and to not overly complicate the first of many agreements. Considering

the document from a marketing perspective can help remove some of the initial roadblocks.

YOU NEED TO READ THE ENTIRE THING

While it is important to be accommodating in the negotiation, it is still necessary to take the document seriously. Lawsuits can emerge years after a NDA is signed, and ensuring you have obeyed all included clauses can protect you in case of litigation.

Even if the agreement seems like a boilerplate template, be sure to read it carefully. The last thing you want is to discover an unfavorable clause after you have executed the agreement.

One example of an overly-inclusive, one-sided clause that was discussed during the breakfast was:

“Neither party shall attempt to contact, deal with, profit from, or in any manner solicit any of the other party’s personnel, business contacts or associates, customers or vendors, or use the Confidential Information in a manner competitive, either directly or indirectly with the other party.”

BUSINESS OWNERS ARE NERVOUS

Some of the largest roadblocks in an NDA are rooted in the seller’s inexperience with the private capital markets. While they may be exceptional at running their company, their knowledge tends to wane for these transactions. Since they have spent much of their life building this business, they are afraid of making costly mistakes.

As a result, business owners tend to be more focused on every detail of the agreement, hoping to avoid any risk.

Although intermediaries and financial sponsors have worked with hundreds of NDAs, many business owners will sign a handful of NDAs in their life, making it extremely important.

Many business owners “paper up and lawyer up,” explained one Member. Since they are not sure about the normal procedures, they often feel the need to become excessively cautious and protective. It is the job of a good M&A advisor to help the business owner understand the real nature of the NDA and where emphasis should and should not be placed.

If the business owner is still nervous about the agreement, try to determine if there are other complicating factors. As one Member explained, “Most often, these businesses have complex family dynamics and they are just as worried about the secrecy of their family as the secrecy of their business. They don’t want their neighbors knowing what grandpa was up to.”

Fully understanding the business owner perspective can pave the way for a healthy negotiation process.

Deal Professionals, Negotiation, Regulatory/Legal

Some of the largest roadblocks in an NDA are rooted in the seller’s inexperience with the private capital markets.

7 Pitfalls to Avoid Between LOI and Deal Close

Mason Myers | Greybull Stewardship November 6, 2014

When selling your business, reaching the Letter of Intent (LOI) stage is a great indicator

of success. But, the process is far from over. There are many steps that still lay ahead that can derail or ruin the transaction. Below are 7 pitfalls to be aware of between the LOI and the closing of the transaction:

1. FIRST, GET THE LETTER OF INTENT DONE WELL, AND READ ALL THE LEGAL DETAILS.

The first step to moving from letter of intent to closing is to make sure that everyone understands all elements of the letter of intent, and that the letter of intent has a reasonable amount of detail. Misunderstandings and miscommunications will blow-up a deal very quickly if the parties have different interpretations of the terms.

In the midst of negotiation, it may be tempting to leave a detail for later, or hope the other party didn’t notice some important detail, or leave an open item to later. There is no one way to do things, but if you truly want the deal to happen, I have had much more success taking the extra time to explain a term or go over something again to make sure that everyone is on the same page. The LOI sets the pace for the rest of the process, so it is important to do it well.

2. KEEP THE BUSINESS ON BUDGET AND PERFORMING WELL.

Ensuring that the business remains on track is critical during the process from LOI to closing. Although it may take a great deal of focus to close the deal, keeping the business running according to plan is necessary for the transaction. This is the most important, of many things, to balance during the closing process. Among private equity buyers, you will hear wisdom shared from investor to investor with things such as, “95% of all bad deals were off

budget during the closing process.” The buyer will be watching every twitch of the business with extreme scrutiny. To a buyer, there is nothing more comforting than seeing the financial results come in as expected. Even better for everyone is having the financial results come in ahead of budget. Yes, this is true even when you are the seller wondering if you could have gotten more for your business because it makes the buyer want to close the transaction even more and maybe some small horse trade will go your way in the end (and, there is always one more horse trade).

When the financial results are not on target, it forces the buyer to spend time and energy trying to figure out if the miss is a short-term blip or something more fundamental. Better to avoid having the buyer to think twice about anything.

Most deals require the seller to operate the business as usual during the closing process. This should be obvious and intuitive to all involved. However, I have seen sellers try to be clever and change some aspect of the business during the last months or weeks to try and tweak the deal to be more favorable to them. This never works. First, it is counter to the spirit of the deal to keep operating the business as normal, and it's very difficult to change any reasonable size organization from their normal operations without creating problems, both intended and unintended. Furthermore, it is in the seller's interest to keep the business operating normally just in case the transaction does not close. It is a fact of life that not all deals close after a signed letter of intent. The seller needs to be aware of this and not make any adjustments

that they would not make if they were not selling the business. In particular, do not change a strategy to fit the buyer until after the close.

3. IF SOMETHING BAD HAPPENS, INFORM THE BUYER IMMEDIATELY.

Business results are rarely perfect and on budget. If something happens, the best policy is to be up-front and inform the buyer immediately, just as you would want to be informed if your roles were reversed. If done well, this can increase the buyer's confidence in the seller and the business. If done poorly, it can torpedo the transaction in a heart beat. In one recent situation where I was not directly involved, the seller lost several clients in late

November

that was going to reduce their revenue by >20% (probably only for a few months, but it wasn't totally

I have seen sellers try to be clever and change some aspect of the business during the last months or weeks to try and tweak the deal to be more favorable to them. This never works.

clear). The seller did not tell the buyer until the December and January financial statements were ready, and it cratered the deal. They may have had a chance to save the deal if they had been up-front immediately. More importantly, they should have done everything in their power to keep those clients and keep the business on track (or presented more conservative financial forecasts that accounted for some potential lost clients).

4. HAVE SCRUBBED AND ANALYZED YOUR PREVIOUSLY PRESENTED FINANCIAL STATEMENTS.

Most serious buyers will perform a “Quality of Earnings” accounting due diligence on your company. This means that they will review, in detail, the financial statements that you have previously presented to make sure the earnings presented are high quality. It is inevitable that they will find various adjustments that make the earnings a bit better and a bit worse than expected — that is normal. However, it will save sellers a ton of time if they have performed their own analysis to find the unusual items or the items that the buyer may ask about. It is much more efficient to be prepared up-front than to scramble around trying to understand the questions yourself and to explain what the buyer may be finding.

5. BE ORGANIZED.

The buyer will need all sorts of information about the financial results, legal, insurance, human resources, major contracts, etc. Of course, the seller wants the information to be strong and supportive of the picture that was painted during the sale process. Almost equally as important is how the information is organized and presented. Buyers appreciate indications that the company is well managed and organized — such indications provide more confidence to the buyer.

6. MANAGE THE LAWYERS — DON'T LET THEM MANAGE YOU.

The lawyers view their job as doing everything they can to protect you, so they will always take the most conservative path and recommend the most protected, conservative position. There is nothing wrong with that, but if both parties take that same stance, there is no room to find a middle ground that makes sense. The lawyers work for you — you should have the confidence to tell them what you want, make the final business

decisions around the deal, and not let the lawyers manage you. Finishing the Letter of Intent does not mean that all the deal decisions are done. There are many more small details and decisions in the final documents, and both parties need to continue compromising and negotiating the details that are not covered in the Letter of Intent.

7. COMMUNICATE WELL WITH EVERYONE INVOLVED.

Special effort needs to be made to communicate (probably more than you think) among all the parties. And, special effort should be made to think about the best methods to communicate everything. Never take a shortcut by firing off an email when a phone call would be better. Everyone is on edge, and making sure to communicate enough — and via the best method possible — pays off big time.

Deal Professionals, Negotiation

Key Learnings from a Successful Search Fund

Tony Bautista | Long Trail Leadership
September 17, 2014

After having spent 12 months as a “searcher” I finally got what every buyer dreams about: a company to call my own. The ink had not even dried on the purchase and sale documents when it struck me that transitioning from the search to actually running a business are two entirely different tasks.

The company I bought is a simple to understand business that conducts fire hose and related fire equipment testing for firehouses across the country. It was an honor to find a company that helps keep America’s heroes safe while on the job. What is not simple is the actual process of taking over the company — a process that requires a careful juggling of previous ownership, financing, and employees.

I’ve learned 4 important lessons since my purchase that may prove useful for soon to be business owners.

1. SETTLE ON THE RIGHT FINANCING DECISIONS FROM THE RIGHT SOURCES

Finding the right financing can be just as difficult as finding the right company. The best combination of debt to equity can be confused by the plethora of choices, such as SBA loans, seller financing, owner retentions, and partner splits. It is important to keep in mind that the cheapest source of funding may not always be the best option. An example of this is seller debt. Given today’s low interest rates, why would anyone decide to take on usually more expensive seller paper? The benefit of course is non-financial. By having the seller take a financial position in the company post-sale, the buyer is almost guaranteed that they will have the full cooperation of the seller to help if any issues arise. This may be worth more than any non-compete or consulting agreement between the parties.

Just as important is the flexibility of all the parties involved. Be sure to analyze both upside and downside revenue scenarios so everyone understands the risk and rewards. The downturn of only a few years ago hurt many companies as their revenues were hit hard yet banks still demanded payments. I spent many weeks sharing best case and worst case scenarios with each funding source and confirmed they will still be committed.

2. BE OPEN WITH EMPLOYEES BECAUSE THEY ARE THE COMPANY’S GREATEST ASSETS

The first day a new owner walks on the premises is the first day the acquisition should be announced to every employee. Afterwards, they will all have one question in mind: “what does this mean about my job?” In my company the employees are the most important asset to success and letting them know their jobs are safe is the first step in gaining their trust.

The second step is asking them what they liked, didn’t like, and what they would improve about the company today. The feedback was tremendously helpful. The best lesson I learned was that payroll checks could sometimes take too long to get to each worker. By figuring out a way to optimize the flow from hour entry to check in hand I made everyone a little bit happier.

Without that valuable input from my employees, I would have never known about this relatively easy-to-solve pain point. I learned that the transition of ownership for a company is a rare opportunity where management can make changes not hampered by tradition and employees can be critical in making sure those changes are for the better.

3. HEED THE ADVICE OF PREVIOUS MANAGEMENT

You bought the company to improve it, that’s a given. However, do realize that the company is where it is today because of previous management. There is information contained in habitual routines and dialogues that usually can’t be gleaned during due diligence.

Something as simple as imitating the way in which previous ownership would talk to customers can give insights into how the company keeps its customers happy. Physically

creating a script based on customer conversations will allow new ownership to analyze current protocols so they can be iterated on in the future. Not everything will make sense at first, but the best way to figure out what works and what doesn't is to try it for yourself. I know I've been surprised many times by doing or saying things to customers that at first I thought wouldn't work, but after seeing how they responded, I better understood the original reasoning and kept the original approach. During the negotiations, work out an appropriate transition timeline that allows you to gain the knowledge you need to successfully run the business.

4. TAKE IT SLOW

Being at the top of the management hierarchy usually means being able to institute changes quickly. However, do not mistake quick with effective. While some changes should be made immediately, do not rush decisions without being fully informed or having the hands-on experience. My advice is to run the company as it has always been run for the first few months. As new ownership grows more confident, improvements can be made slowly over time.

For example, I would advise not to change the benefits package during the transition period. Such a change can cause unease in the company's already anxious employees and it may result in the loss of some of its best performers. Ease employees into the changes and you can reduce the probability for a mutiny.

For many companies the transitional phase can be difficult. The most important goal is not to lose the company's momentum. Dealmakers should be aware that the acquisition is just the beginning of the journey for a new owner.

Deal Professionals, Dealmaker Outlook, Post-Transaction

5 Common Mistakes to Avoid When Raising Capital

*Jeff Villwock | Villwock Advisory Services
October 28, 2014*

Raising capital for a business, whether it is a start-up or a mature company, can be an extraordinarily frustrating and time consuming experience. Entrepreneurs want to operate and grow their business, not raise capital. But the fact is that for most businesses, the entrepreneur or CEO is responsible for raising capital.

When attempting to raise capital, CEO's very often make some crucial mistakes. These mistakes not only can dictate whether or not the business will be able to raise capital, but also how long it will take and the ultimate cost of the capital. Using the wrong assumptions, raising capital can be impossible.

We believe there are 5 common mistakes that CEO's make when raising capital:

1. UNREALISTIC EXPECTATIONS OF VALUE

Most of us has watched Shark Tank at least once. Just watch one episode and you will likely see this mistake. The entrepreneur goes to professional investors with a company that did \$100,000 in sales last year and confidently tells the Sharks he will sell 10% of his business for \$1 million. What's the chance of this CEO getting funding? Zero.

With few exceptions, investors will pay for what you have already done – not what you believe you will do in the future. Transactions are generally priced as a multiple of last twelve months revenue or earnings.

Sometimes a fast growing company can be given credit for the last quarter results annualized, but that's the exception rather than the rule.

Investors are particularly unimpressed with a great idea and an entrepreneur who models earnings five or ten years out. Discounting cash flow back to today may be worth \$10 million on paper, but generally an idea – even a fully baked idea that only needs capital to start – isn't worth anywhere close to that amount.

Recently a CEO of a company that has been operating for six months called us. He had a \$10 million acquisition ready to be funded. Between his small platform and the acquisition, he told me that the business would be worth \$100 million. He was willing to give up 20% of the company for \$20 million, using \$10 million to complete the deal and another \$10 million for growth capital.

Regardless of how good the idea is – or how good the acquisition is, a deal isn't happening at anything close to that valuation. Why should an investor pay \$20 million for 20% when he could theoretically pay \$10 million for 100%? It makes no sense – but the CEO was absolutely convinced that someone would find this highly attractive.

When raising equity capital, use a FINRA licensed investment banking professional. You should expect them to provide you with an expected range of values prior to a formal engagement. They should have the resources to show the valuations of companies similar to yours, and to detail any private market M&A transactions that have occurred.

2. EXPECTING TO RAISE CAPITAL QUICKLY

We also get calls from CEOs who want to raise capital and the CEO confidently tells us that his business is so compelling that we should be able to close a deal in 30-60 days. Or worse, he has a payroll to cover and hopes we can be in talks with someone next week.

The reality is that raising equity capital generally takes at least 4 months, and any CEO should expect and plan for 6-12 months.

Why?

Private equity firms are working on dozens of deals at the same time. On the first contact, they want to see an Executive Summary of the proposed transaction. That Executive Summary is normally a 2-5 page document outlining the company, its prospects and why it needs capital. If the firm is interested, this is followed up by a Confidential Information Memorandum.

The investment banking firm preparing the Executive Summary and Confidential Information Memorandum will normally require four weeks to gather the information from the company, perform its due diligence, write the materials and generate a list of potential investors who may be interested in the opportunity.

In week 5 the private equity firm is contacted. It normally takes a week or two to get a Non-Disclosure Agreement signed, the Executive Summary sent and feedback received from the private equity firm.

In week 7, the Confidential Informational Memorandum is delivered. Normally firms are given four weeks to process this information internally, to ask questions of the bankers and if interested, to provide the bankers with an initial proposal, or term sheet.

By the time the Term Sheet is delivered, 10 weeks have already gone by. Even if the Term Sheet were instantly accepted, due diligence (legal, financial & operational), negotiating stock

purchase contracts, Board governance and a variety of other issues will easily take 6 weeks.

Four months have elapsed, if everything goes smoothly – and frankly, that rarely happens.

Be realistic about the time involved.

3. EXPECTING TO RAISE CAPITAL WITHOUT INVESTING TIME & MONEY

A corollary to Expecting to Raise Money Quickly, is the expectation raising money doesn't cost money.

Entrepreneurs often forget that raising capital normally entails significant legal, accounting, travel and for those that hire a banker, investment banking expense. It's not as easy as setting up a couple of phone calls resulting in someone falling in love with the business and writing a check.

The process generally entails a significant amount of expense to get to a Letter of Intent for the investment, and then the due diligence starts. A data room may need to be set up, normally at a cost of \$5,000 or more. Much of the entire history of the company is loaded into the data room, including all significant contracts, incorporation documents, financial documents and detailed information on all aspects of the business.

Due diligence teams will converge on your office, talking to your employees, getting into your financial systems, and outside accountants will scrutinize every aspect of your financial statements. At the end of the process, any "dirty laundry" will most likely have been found, and the quality of your financial statements and systems will be tested.

It's all good when the investment is made, but most investors don't just write a check. They review every aspect of your business in great detail, and that costs you money, time & effort.

4. FISHING IN THE WRONG POND – KNOW YOUR TARGET INVESTOR

Entrepreneurs looking for capital typically don't know where to look, or who their target investor is. The CEO of a company with \$10 million in sales might have heard that KKR is a great partner – but KKR won't touch a \$10 million business.

Who do you target? Venture capital? Private equity? Family offices? Wealthy friends? Customers? Suppliers? New joint venture partners?

In many cases, the best capital is capital coming from a strategic partner – someone whose investment will help you succeed.

CEO's need to "fish in the right pond". Sending a packet to 100 venture capital investors is a waste of time, energy & money. Having a single conversation with the right party may result in capital. A quality investment banker who knows your business, your industry and the market will be worth far more than the fee they charge if they can make the right introduction.

5. CEO PLAYS LAWYER

Entrepreneurs often want to save money by being their own lawyer. What's the old saying? "A lawyer representing himself has a fool for a client!" Well, a non-lawyer representing himself is arguably worse.

In today's world, it is easy to find a document on the internet and edit. But transaction lawyers know how to protect their clients, and what deal terms are customary, or mandatory in a private placement. They make sure that the regulatory filings are done – many CEOs have no idea that the SEC needs to be notified of most private placements through Regulation D.

Entrepreneurs often are willing to pay a broker or finder a fee on a successful raise. After all, if Joe can introduce me to an investor who writes a check for \$10,000,000, why not pay him a fee?

Most CEOs don't know that unless Joe is part of a FINRA licensed firm and it is the firm, not the individual, who formally does the private placement, then Joe, the CEO and the company have taken on a huge risk.

Securities law says that if a non-FINRA licensed person is paid a success fee, then the investor can, at any time, ask for all their money back. So five years after the investment, the company has a financial downturn and is nearly bankrupt. The investor can demand that the investment be rescinded and ask for all their money back. Of course a company in this situation can't pay back the money, so the investor sues the CEO, and will most likely win.

Raising capital has always been difficult, but since 2008 it has become even more difficult. The good news is that the private equity firms have a lot of capital to invest today, and everyone is very busy putting money to work. This is the best environment since 2006.

Realize that raising capital requires a significant amount of your time, energy and will cost money. Budget out the time required and the financial, accounting and legal resources required to complete the process.

Raising capital is stressful enough without having unrealistic expectations. Hopefully this article is helpful in framing your expectations and increasing the probability of your success.

Business Owners, Preparing for a Transaction

Should You Be Conducting Values Due Diligence?

Billy Fink | March 20, 2014

Investors conduct all types of due diligence to uncover skeletons in the closet. Legal due diligence can uncover outstanding lawsuits; cultural due diligence can explain high turnover rates; IT due diligence can root out any incorrect patent filings or licenses.

But what type of due diligence uncovers future conflicts with the current owner-operator?

As financial sponsors partner with business owners, alignment between the two parties — especially regarding the future of the business — is critical to a successful transaction.

“One of the most important things we do when speaking with a business owner is to ensure that we have an understanding of their business values and the end-result of the desired transition,” said Kevin Coughlin of Coughlin Capital. To address these issues, Coughlin Capital employs a type of ‘values due diligence.’

According to Coughlin, misaligned values can threaten the success of an investment. “Our values, with regard to how the business will be run, need to align. If they do not, it can cause significant headaches and hurdles in the future. If the values are clearly conflicting, it’s a non-starter.”

As a result, Coughlin likes to conduct values due diligence in addition to the regular financial, legal, and operational diligence. Instead of relying on regular management meetings, it is advisable

to have direct and clear conversations around values. “To flush out these [value-related] issues, we sit down and discuss the owner’s plan,” he explained. “We want to really understand how the owner sees the future of the company.”

WHEN SHOULD IT HAPPEN?

“This conversation can happen at any time before the closing of the deal — but the earlier in the process, the better,” said Coughlin. “For a successful deal, there still needs to be a level of trust, and the earlier the conversation, the easier it is to develop the trust and have a sincere connection around business values.”

However, don’t have the conversation too early. Prematurely discussing these values can undermine the entire purpose of the conversation. Coughlin explained, “If you tell them you want to sit down to talk about business values, they won’t do it unless they think a transaction is likely.”

The ideal time for the conversation is “sometime after an LOI, but before the closing of a deal.”

WHAT SHOULD BE DISCUSSED?

This diligence of values needs to be more than another management meeting, and it shouldn’t be mere lip service. Candor and honesty are helpful in ensuring the relationship starts on the right foot. “There are certain changes in governance and operations we want to implement and there needs to be a base level of trust between the business owner and us. As a result we need to buy into each other.” Building that mutual trust is critical to ensuring optimal post-transaction efficiency.

To gauge the mutual respect, Coughlin likes to discuss topics like “how we will treat each other as owners, how customers will be treated, how employees will be treated, how vendors will be treated, how the day-to-day operations will be run, etc.”

He added, “While the owner’s business values are not a reason to invest in the business, they can be a reason to walk away.” As a matter of fact, they have been. “We walked away from one deal in the past two years for business values-related reasons. We had the conversation and it became clear right away that there wasn’t a match. We would prefer to walk away from a good deal than do a deal that would fail.”

HELP STAND OUT

The values conversation, in addition to helping prevent future conflicts, can also help you stand out from the competition. “I really believe that most of these retiring entrepreneurs want more than a simple check; they want a real transition with real mentorship...they want succession,” previously explained Benjamin Gerut of the Kuzari Group.

He continued, “Buyers must care about the employees. After working with many of these people for years or decades, it is hard for me to imagine an owner being comfortable simply selling to a PEG without any comfort as to the long-term future of the company and its human resources.” By having these explicit conversations, you can help demonstrate to owner-operators that you are dedicated to having parallel values.

Deal Professionals, Dealmaker Outlook, Due Diligence

8 Negotiation Techniques When Buying & Selling Companies

Peter Lehrman | February 27, 2014

If you want to master negotiation, it’s going to take time, talent, homework and practice. However, there are a few key negotiating techniques and resources that are crucial for success when closing a business investment, growth capital, or M&A transaction.

Since buyers seek to acquire companies at the lowest possible price and most favorable terms, and business owners and entrepreneurs are looking to realize the fruits of their labor by maximizing price and favorable seller terms, negotiation skill is critical to completing any significant financial transaction. Despite the tension, there is always one critical goal that buyers and sellers share: getting a deal closed that benefits them and their stakeholders.

To that end, here are eight negotiation tips and techniques that we’ve found can help entrepreneurs, investors and strategic buyers accomplish their common goal of closing the deal.

REMEMBER: PRICE ISN’T EVERYTHING

When it comes to the sale or purchase of a company, it’s very easy to fixate on the price. It’s a key piece of the negotiations, but hardly the only one. The terms matter too. If it’s not a full sale, what stake is being transferred? How much control? Does the buyer get the first refusal for future transactions? Does the sale agreement provide

the buyer with any recourse against the seller if costly problems arise immediately after the transaction? Is there any seller financing? By creating many terms beyond just price, buyers and sellers can find out what are the top priorities for the other side, and this allows both sides to ultimately make concessions to the other to keep the deal moving forward. Perhaps the seller is comfortable with an earn-out provided the buyer is willing to pay a higher price. If you don’t put an earn-out term on the table, the deal might be off.

MAKE STRATEGIC CONCESSIONS

“Concessions are often necessary in negotiation,” says Harvard Business School professor Deepak Malhotra. “But they often go unappreciated and unreciprocated.” Malhotra offers four strategies to make sure your concessions are returned in kind.

- First, make sure that your counterpart is aware that you have given up something of value.
- Second, define how your counterpart can return the favor. Then demand it.
- Third, if you don’t trust your counterpart to reciprocate, make a contingent concession. In other words, offer to yield on something only if the other side meets a certain condition.
- Fourth, make concessions in installments. Malhotra points out that people are happier to find two \$10 bills on consecutive days than one \$20 bill. We like our good news spread out, including in negotiations.

KNOW YOUR “WALK-AWAY” NUMBER

A buyer or seller needs to enter negotiations with an understanding of the reasonable range in potential sale prices for the asset. You should know what’s the highest and lowest

price the asset could reasonably sell for. Just as important, buyers and sellers must know their “walk-away number”; this number is your final threshold for consummating the deal. This will depend on your BATNA, or Best Alternative to a Negotiated Agreement. Knowing your walk-away number going in takes research and preparation, and sticking to it will help you stay disciplined.

KNOW YOUR OPPONITION

In order to get the other party to agree to a deal, you need to intimately know what their interests are. Getting To Yes, one of the “Bible” books on negotiations technique, recounts that the 1978 Camp David negotiations started with Israel and Egypt posing irreconcilable claims to the same piece of land. It was only when the sides recognized the other’s real interest—Egypt’s wanted its previous borders and Israel wanted its security—they were able to realize an agreement both sides could accept. Egypt got the land but promised to demilitarize it. Also remember that there’s a distinction between your negotiating counterpart and the organization they represent. His or her compensation structure and career goals could be playing a role in their decision-making. Understand what’s driving him or her helps you increase your bargaining power.

MAKING THE FIRST OFFER ISN’T ALWAYS A BAD THING, IT’S OFTEN A GOOD THING

You’ll often hear the advice to not tip your hand, let the other guy show his cards and make the first offer. But there’s a clear advantage to making the first offer: it anchors the discussions. Studies have shown that the first named price in a negotiation significantly influences subsequent prices in the discussion. There’s also an advantage to using precision when you name your price. There is a caveat: this strategy is especially useful when you are confident you have an information

advantage in the negotiation. If you’re not in that position, playing coy might be the ideal strategy to avoid low-balling yourself. For those curious about research on the subject the academic paper “First Offers as Anchors” is an enlightening read.

DON’T FEAR SUNK COSTS

As negotiations progress, it’s easy to get tunnel vision. So much time has been spent and effort has been exerted, how can you walk away empty-handed? Sometimes you have to because that’s the best option. As was already pointed out above, it’s important to know your alternatives and walk-away number before you enter the negotiations.

SHAKE HANDS, THEN SECOND GUESS

After the deal is done, second-guessing can be helpful. Research has shown asking yourself what more could you have done following negotiations can make you more effective. A 2009 study from professors at Haas, Kellogg, and Ohio University found that the second guessers learn more and perform more effectively in the future. Not all self-reflection is equal though. The experiments found it’s better to think about what else you should have done rather than what you did but should have avoided. “Particularly effective negotiators learn from experience by mentally adding rather than subtracting from reality,” wrote the researchers.

RESEARCH, RESEARCH, RESEARCH

As a number of the tips above already suggested, the buyer and seller need to walk into negotiations after doing their homework. You need to research the asset, its value, your negotiation counterparts and other textbook (and non-textbook) due diligence items beforehand.

For those curious to read more about negotiations, the aforementioned Getting To Yes by Roger Fisher and

William Ury is an accessible and useful primer on the topic. And Harvard Law School’s Program On Negotiation has a blog and free newsletter.

Business Owners, Deal Professionals, Negotiation

3 Ways to Keep Customers after an Acquisition

Billy Fink | February 27, 2014

Any merger or acquisition is rife with uncertainty. And customers can be the most sensitive to that uncertainty. Worried about how the transaction will impact their end experience can cause them to flock to different competitors.

As an article in WSJ explained last year, “Customer defections are a major reason why more than half of all mergers fail to deliver the intended improvement in shareholder value.” The article continued, “The trouble is that merged companies tend to focus primarily on quickly capturing synergies and avoiding major technology disasters. They typically lose sight of customers at the time when they are most likely to bail.”

While there are many components to consider in executing a successful post-merger integration, customer focus is critical. Below are three ways to avoid losing customers during an acquisition or merger.

COMMUNICATE

Probably the most important strategy to prevent customer attrition is clear and effective communication. If customers feel uncertain about direction of the merger, they will be very sensitive to any dips of

communication and service. “You can not afford to miscommunicate with them, or you risk losing them,” explained Bob Hatcher of BetterSell Solutions. “Whether you are a highly efficient ‘low cost provider’ or a high end, consultative ‘trusted advisor’ your clients want to know how the merger will affect them.”

However, not all communication is good communication. A recent Bain study learned that the “companies that do the best job of retaining customers — and attracting new ones — adopt the customer’s view of the merger as they make important integration decisions. They typically establish teams tasked with evaluating every step in the integration and every change that is made through the eyes of the customer.” In short, “they act as the customer’s advocate.”

This ability for the company to put itself in the customer’s shoes allows it to understand the pain point and then effectively and appropriately communicate around those problems and questions.

Once identified, it is critical for customer-facing employees (typically salespeople) to have consistent answers to these questions. “How your people talk and answer questions from clients and prospects is critical to their retention,” explained Hatcher. “Train them in how to answer questions and to ask questions. Train them to anticipate questioning sequences and to answer them assertively and with confidence. These are the people who will implement your communication plan.”

WATCH OUT FOR COMPETITORS

Effective communication also helps with another post-transaction threat to customer retention: competitor thievery. Very often, when competitors hear the news of a merger or buyout, they will try and use customer uncertainty and doubt to their advantage.

A recent Deloitte report, which reviewed customer attrition in bank mergers, explained, “Another common reason for [customer] switching was receiving compelling competitive offers from other institutions. Specific experiences in this category include offers of more appealing products, improved returns on savings, loans with lower interest rates or more flexible lending terms, or services that made banking more convenient.” While these examples are specific to commercial banks, the implications hold true for all businesses across all industries.

The best way to mitigate the threat from pilfering competitors is to make clear the value of the newly-combined or newly-acquired business. Firms can “go on the offensive and proactively communicate their strengths and the benefits of the acquisition for the customers,” explained the Deloitte report. “These communications can remain positive and go beyond simply assuring customers that the changes will be minimal and that the service will not be disrupted.”

If push comes to shove, it can also be valuable to arm salespeople with tools necessary to “deliver an exceptional experience during a time of change,” explained Laura Miles and Ted Rouse in a WSJ article. “That sometimes requires empowering employees in new ways — such as enabling them to immediately offer discounts or refunds.” This ability to respond to competitive offers encourages a better customer experience and reduces the likelihood of attrition through competitors.

ENCOURAGE MULTIPLEXITY

Sometimes, unfortunately, the reason for customer attrition comes from within. Mergers or acquisitions can cause significant turnover post-transaction, especially in lower middle market transactions where the founders are exiting entirely. In these businesses, personal relationships are critical to the client.

“Potential client loss is an immediate fear when an executive — or in some cases executive team — jumps ship. For service industries like advertising, law, and consulting, where clients are attracted to the human assets rather than the production side of the business relationship, the likelihood of significant client losses when a team leader leaves is even greater,” explained Michelle Rogan in a recent INSEAD article.

One of the best ways to prevent customer attrition thanks to employee turnover is through multiplexity or, as Rogan explained it, “diluting the control held by individual executives by creating a number of ties between the client and the company.” If relationships with clients “were held by several agencies in the firm, no single agency or executive could control the relationship, and the likelihood of client loss following an executive departure [is] significantly lower.”

This strategy may be tricky to implement post-merger, since it may send the wrong signal to customers, businesses with existing multiplexity are inherently more resistant to customer attrition during turnover.

Deal Professionals, Post-Transaction



The Evolution of LP/GP Relationships: Moving Closer to the Deal

Cody Boyte | August 26, 2014

Over the last few years, relationships between limited partners and general partners in private equity have started to evolve. For a time, GPs had a pretty tremendous advantage. The public markets weren't producing predictable results, real estate was down, and emerging markets were still rocky. LPs were sold on the IRR of previous funds and, with few other places to put their money, would commit fairly quickly.

But for many funds, the simpler times of raising a fund and returning capital in a decade are drawing to a close. LPs are increasingly scrutinizing results of individual deals, digging deeper during fund due diligence and either co-investing or funding individual deals more often. In many cases, the belief that GPs are investing to get fees, not carry, is what pushes LPs towards different models.

The problem has been exacerbated as more and more funds are created. According to Preqin, there are now 2,199 funds in the market — a record level. The shifting dynamics and sheer number of funds is causing many LPs to seriously reconsider their existing relationships and investments. The ability to raise another fund in the future may come down to being creative during fundraising and further aligning pay with results.

LPS ARE LOOKING FOR NEW GPS

As LPs start considering ways to shake up the model, they're starting to look past their traditional "core relationships." Coller Capital found in their Global Private Equity Barometer

that 85% of LPs are not planning to re-up with GPs whose last two funds they backed. Instead, they're seeking fresh relationships and ideas. Nearly 70% of North American LPs are planning to back new, first time funds directly rather than relying on funds of funds to find new deals.

Coller Capital partner Stephen Ziff explained to Investments & Pensions Europe, "Often, talented individuals or teams will leave big franchises that perhaps aren't offering them the challenges they expect, in order to start up on their own – and LPs that know them well are prepared to back them." As a result, the amount of competition is continuing to grow.

Although one recent study found that the top private equity funds had persistent outperformance of other funds by 7-8% per year, one of the paper's authors noted, "The problem is that there is a lot of luck mixed in with the skill. If you want to find the truly skilled managers, you'll probably have to look at something more than just past performance."

Though some LPs have had allocations for emerging managers in the past, the proportion seeking ideas beyond generalist buyout funds seems to be slowly climbing with LPs trying to find real beta in individual managers.

DEEPER DUE DILIGENCE

But, as LPs search for the best returns, they are looking beyond simply the team.

"The LPs we talk to are looking for evidence of a repeatable model," Hugh MacArthur, Bain & Co's head of global private equity, recently said to the Wall Street Journal, "The due-diligence process is a lot more intense than it was seven or eight years ago."

Instead of simply listening to a few pitches and signing off on a fund, LPs have started digging into past funds on a deal by deal basis. They're beginning to recognize that they can do much of the same due diligence on funds as their funds do on potential acquisitions. GPs now need to have a much better understanding of their value add and their competitive landscape.

Investors are starting to ask about deal sourcing strategies, what made

each deal successful or unsuccessful, and whether the investment patterns seem to be repeatable or were simply luck. As we've found in our own conversations with different private equity groups, few have repeatable sourcing strategies.

THE ERA OF CO-INVESTMENTS AND DEAL-BY-DEAL INVESTMENTS

The biggest changes, however, seem to be in the structure of the investments themselves. With more than 60% of the LPs surveyed by Prequin for their special report on co-investments noting that they'd trade lower hurdles for lower fees, it's obvious that LPs are seeking new ways to get access to private equity at lower cost. And they're not waiting for the funds to change on their own, they're pushing the changes.

As the Coller report noted, nearly a quarter of LPs have backed GPs on a deal-by-deal basis in the last 5 years. Prequin's report found that of the LPs they tracked, "43% are actively seeking co-investment rights when committing to funds, and a further 11% are considering such opportunities." Even Pensions & Investments noticed the discrepancy between direct returns and fund returns in a recent article, noting that the public data from CalPERS showed direct investment net IRR of 12.8% versus an 11.4% net IRR for its commingled funds.

With LPs becoming more sophisticated, private equity funds will have to find new ways to create alignment whether it's through investments on a deal-by-deal basis, co-investment commitments, or through more flexible terms on fees. Investors are willing to back new teams, direct invest and dig much deeper into the actual strategies used by different funds to ensure they're getting the returns they need. Are you prepared?

Deal Professionals, Dealmaker Outlook,
Fundraising & IR

Could Freelancing be the Future of M&A?

Vik Ashok | SpareHire June 26, 2014

M&A has historically been an old-fashioned industry characterized by large institutions and structured career tracks. However, a change is on the horizon.

For most M&A professionals, a career starts at investment banks, where thousands of analysts are hired each year and rigorously trained in financial analysis, Microsoft Excel, market research, and presentation building. While a few climb the ranks to become relationship-focused managing directors, the majority leave, switching to investment careers at private equity firms and hedge funds, strategy careers at large corporations, or abandoning the M&A world altogether.

This rigid structure is beginning to evolve as many entrepreneurial dealmakers choose to branch off and pursue freelance options or establish their own boutique shops. Technology, shifting industry dynamics in the M&A industry, and a generational shift towards freelancing are accelerating this trend.

TECHNOLOGY & FREELANCE

The power of technology-enabled freelancing can be seen in a variety of industries.

Many of the most familiar industries rely on freelancers to deliver services to customers, including software development, medicine, journalism and law. Nearly 33% of the entire U.S. workforce is made up of freelancers, and this number is expected to swell to 40% by 2020.

These days, professionals are using technology to build careers on established online work marketplaces like Elance and oDesk. They are finding customers through Angie's List and ZocDoc, and using platforms such as Airbnb and Lyft to transform themselves into independent hotel operators and taxi drivers. Even pedigreed ex-big firm lawyers are making lucrative careers as freelance corporate lawyers, finding short-term legal projects through platforms such as Axiom Law and UpCounsel. In many cases, these freelance lawyers are supporting M&A events for smaller companies who cannot afford the high cost associated with hiring a big firm.

IS M&A NEXT?

The investment world is no different. At SpareHire, we are seeing more and more M&A professionals choose freelancing as a career, driven by a few recent industry dynamics:

1. As is the case in the legal industry, training programs at large investment banks equip thousands of new professionals with robust skill sets every year, creating large pools of talent with valuable skills to offer.
2. Most banks have pyramidal organizational structures, forcing talented mid-level and junior professionals to leave in search of other careers while senior professionals stay in place.
3. Industry headwinds such as declining management fees have caused investment firms and transaction service providers (e.g. strategy consulting firms, accounting firms, advisory firms) to recalibrate their HR structures and work with less.
4. The industry's demanding work schedule leads to a high churn rate, and many talented M&A professionals voluntarily leave the industry each year to raise families and pursue other passions.

The result is a large, experienced pool of talent looking for new opportunities.

While freelancing is by no means new to M&A – anyone from the industry knows at least a handful of former investment bankers turned independent brokers –these types of freelance roles have traditionally been limited to seasoned professionals with rolodexes.

Thankfully, technology is making it easier for these talented M&A professionals to function independently, and for younger professionals to gain experience and build their networks. Instead of relying solely on personal contacts, the modern deal professional leverages tools and networks to succeed.

In particular, people are becoming more comfortable engaging in large transactions online (not the case five years ago). Rather than scrambling to source transactions through small personal networks, investment bankers, capital providers and companies are now connecting and engaging through a host of crowdfunding sites like AngelList or online business development platforms like Axial. Online marketplaces like SpareHire make it easier for independent finance professionals to find short-term projects and for boutique investment firms and advisory shops to find and engage flexible talent.

All of this is made possible by the internet – small, closed networks are quickly being replaced with larger, more interconnected ones characterized by better information flow and increased interaction.

WHAT'S NEXT?

The economy is becoming more entrepreneurial every day. Whether you are an independent M&A professional who just left a big firm and is looking to freelance or an industry veteran seeking flexibility, new

technology is making it easier and easier for you to create an independent career. Harnessing this technology can help you promote your services, expand your network, engage with other M&A professionals, and find new work opportunities.

Deal Professionals, Future of Capital Markets

Should Business Brokers be Franchised?

Billy Fink | August 7, 2014

As competition in the private capital markets reaches an all-time high, many individual business brokers are finding their livelihood less and less predictable. Business owners are increasingly searching the internet, making brand awareness and access to a wider network of experts that much more important in securing a client.

Many believe the best strategy for smaller, independent M&A advisors and brokers is to join a franchise. “It is getting increasingly harder to provide great service to your clients as a small brokerage firm and a franchise system is a viable solution. Brand name recognition and economy of scale can make the process much simpler,” said Roger Murphy of Murphy Business Brokers.

To learn more about the business broker franchise system and why a broker would join one, we spoke with Murphy and Mason Myers of Greybull Stewardship, a recent investor in his brokerage franchise.

FRANCHISES ALLOW FOR GEOGRAPHIC TAILORING

One of the most important benefits of a franchise model is that it allows for a firm to offer region-specific services. “I was convinced that the industry operated differently throughout the country,” explained Roger Murphy. “Local business customs dictate commission rates, whether you charge the client upfront fees, or how the closing process works.” Regional franchises allow brokers to simultaneously access a national footprint while offering services unique to the region and location.

Additionally, having franchised offices across the country allows each office to build the right relationships in the right locations. “To succeed in a region, you need to have relationships with the best lenders, attorneys, CPAs, etc. in order to assist your clients in getting deals done,” said Murphy. Staying up-to-date on all these relationships can be challenging without specialization by region.

ADMINISTRATIVE SUPPORT & BRAND CONSISTENCY

A franchise model allows for unique economies of scale — particularly when it comes to administrative support. Murphy said that it was a “gross misuse of time for business brokers to have to do both the dealmaking and the back office work.”

Instead, his strategy is to “allow the brokers to do what they do best, which is spend their time with the clients and developing referral networks while they leave the back office functions to the us at the corporate office.” He continued, “Our brokers can now focus entirely on the dealmaking part of the business. My hope is that our people have more time to be out with the client and making deals”

Murphy, like many other brokerage franchises, is enabling the brokers to focus solely on building and maintaining the relationship by

covering most marketing needs. “We create all the marketing materials for them that they will need: print, email campaigns, and other lead generating programs. We also provide all the website material, do all the technology work, manage e-mail systems, etc.”

IMPROVED ACCESS TO INFORMATION

Mason Myers also pointed out that the franchise model offers unique informational benefits for brokers as well. “Whether it is market comparables, transaction information, or general regional knowledge, a network of brokers can invest in marketplace and deal information which an independent broker could never afford,” explained Myers.

He continued, “When you are part of a network, you have a lot of expertise available to you. If it is a type of business you haven’t sold before, there is someone in the network with experience selling that type of business. The whole is bigger than the sum of the parts because the entire network can take advantage of the experience of all the people in the network.”

BUT, THERE ARE CHALLENGES

Although there are benefits to being part of a franchise model, it comes with its own challenges and difficulties. “One of the biggest challenges is the startup time it takes for new people to earn money — about 9 months or so,” explained Murphy. “We try to shorten that process so that the franchise can become profitable as soon as possible.” This uncertain profitability and the irregular revenue streams for most offices can create a serious burden on business. It can also be tricky for a new broker just starting out.

An even larger challenge is ensuring the consistency of brand and talent. Unlike other retail franchises, which can succeed with formulaic repetition, success in the private capital markets

requires an immense amount of effort, experience, and skill. Every individual broker ends up building their own brand and skill set, which may be positively or negatively affected by the other brokers in their office.

As Murphy explained, “Getting people properly trained is also a challenge.” He continued, “Our industry is woefully lacking in formalized training programs. For years, we have required every person to come to Florida for one week of initial training. There is a lot of stuff we throw at them — it is like drinking from a firehose.” Murphy and Myers are planning to grow the education program even more. But, can classroom education effectively prepare a new advisor on all the intricacies of a process? What about more advanced training for experienced brokers?

And, inevitably, there is always the flight risk. After spending hours and dollars training and equipping a new franchisee, there is the risk that he will take that regional specialization, relationships, and knowledge to create an independent brokerage in the community. Neither Myers nor Murphy considered this a very serious risk, believing that their franchisees would stay within the Murphy family as long as it continued to offer great training programs and a very effective network of support and knowledge.

Client Acquisition, Deal Professionals, Future of Capital Markets

Will IPOs Ever Return to the Middle Market?

Billy Fink | July 24, 2014

IPOs are in vogue right now. In the last month alone there was the best IPO week since 2006 and PE IPOs reached their highest ever level.

But, not all companies are getting access to the IPO party. These flotation have largely been reserved for much larger firms with significant market caps.

The small- and medium-sized businesses have largely been ignored in the IPO market for years. And chances are — due to regulatory concerns, investor preferences, and the increasing effectiveness of the private capital markets — the smaller IPO will not return.

Here’s why...

COMPLIANCE CHALLENGES

In a recent interview, Marc Andreessen explained that regulatory burdens are one of the primary reasons that IPOs became unfeasible for smaller companies.

“The compliance and reporting requirements are extremely burdensome for a small company,” explained Andreessen. “It requires fleets of lawyers and accountants who come in and do years of work.” While these regulations are intended to protect the small company, he believes it has “the opposite effect.”

Andreessen is primarily referring to the Sarbanes-Oxley Act of 2002 (aka Sarbox), whose controversial Section 404 dealt a blow to small company IPOs. The section was so problematic

that the SEC learned that 70% of small companies considered going private again after Sarbox's Section 404 was implemented in 2002.

While compliance may have driven down the small company IPO, it isn't these regulations that are keeping smaller IPOs dead. After all, the JOBS Act modified Section 404 to be more accommodating for small firms. The results have been underwhelming. As Steven Davidoff and Paul Rose explained in their research paper on The Disappearing Small IPO, "Percentagewise, the number of small IPOs [in 2013] was one of the lowest since 1996. The trend instead is toward ever larger IPOs. The number of large IPOs was the largest since at least 1996."

INVESTOR SAVVINESS

If not regulation, then what killed the small IPO? Many pundits point to investor savviness as a factor in the demise. Back in the 1990s, the primary investor in a company's IPO was an individual. Today, hedge funds and mutual funds dominate the stage.

As Andreessen continued in his interview, "The problem is the shareholder base itself has changed dramatically. You've had a dramatic rise in hedge funds. Very short-term trading and dramatic rise in short-selling. If you're a public company, you become the shuttlecock between warring longs and shorts. They bat your stock around like it's a chew toy."

Axial Member Tom Courtney, of The Courtney Group, identified a similarly important impact from mutual funds. "Most mutual fund managers do not want to own more than 5% of a company (because they have to report it to the SEC) and want to be able to sell a position in 3-5 days without moving the price of the stock. Add to this the economics of the mutual fund business, that an equity mutual fund typically becomes a profitable business at around \$200 million in assets under

management (charging 1% a year for expenses) and you can calculate that a stock must have a market capitalization of about \$300 million."

The changing nature of the average public investor made the opportunity for small- and mid-cap companies much less appealing. Since these savvier investors cared less about smaller IPOs, these companies received less coverage from analysts and were traded less frequently. As a result, many of small companies in the public market became unprofitable. The consequence of poor trading can still be felt today — just look at Crumbs' recent bankruptcy.

Since the mass return of the individual investor to the stock market is unlikely, these developments in investor habits have proven much more problematic — and permanent — for the smaller IPO than the more transient regulatory matters.

THE GROWING EFFECTIVENESS OF M&A

Although shifting regulations and investors accelerated the initial decline in small company IPOs, the primary factor that has kept small companies off the public markets is the effectiveness of the private capital markets and M&A.

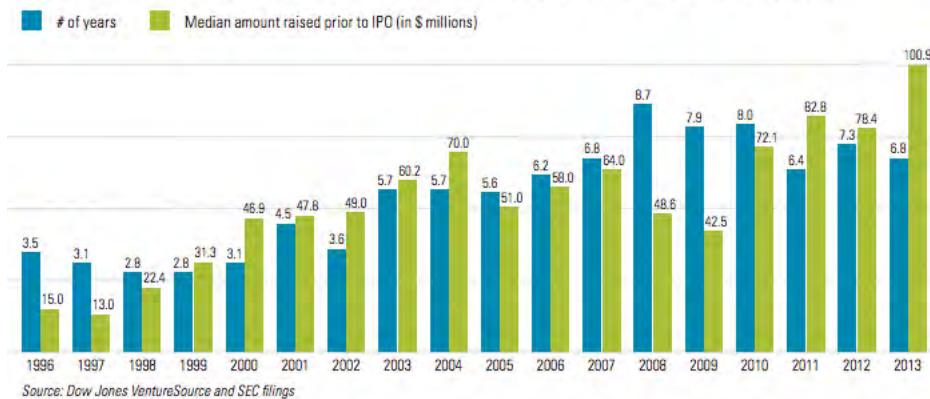
Over the past twenty years, there has been an explosion of deal professionals around the United States. The growing number of private equity firms, search funds, investment banks, and M&A advisors has dramatically increased a private company's ability to tap into the private capital markets. The opportunities have only improved as technologies — like Axial, AngelList, etc. — have developed.

Many business owners and entrepreneurs have realized that partnering with financial sponsors or strategic acquirers can offer comparable opportunities as an IPO, without the additional headaches or risks. As a result, even if the investors and regulators changed back, many private companies would still remain private.

As John C. Coffee, Jr. explained, "Issuers conduct IPOs for multiple reasons: (1) to raise capital; (2) to create a public market and give their founders liquidity; and (3) to generate the highest valuation for their firm through the efforts of underwriters." With a slight exception for #2, partnering with the right financial sponsor or strategic acquirer can be just as effective as going public.

The fact that SMBs are favoring a first stop at the private capital markets can be seen in the amount of capital raised by a company before it goes public.

Median Time to IPO and Median Amount Raised Prior to IPO – 1996 to 2013



(Source: WilmerHale)

The companies that went public over the last four years had raised on average more than \$70M pre-IPO, leaving many of them simply too large to be acquired. After raising that much money, you generally are seeking a \$250-1B+ exit, which is well beyond the means of most strategic and PE acquirers. As such, the only option still available is an IPO.

The appeal of staying private has become even more important in recent years. As baby boomers begin to retire, they are concerned about the legacy of their business, and are seeking strategies that can ensure a dynasty of their choosing. Choosing the buyer/investor of their business can help secure that strategy.

Deal Professionals, Future of Capital Markets, Post-Transaction, Valuation

What Increasing Secondary Deals Means for the Middle Market

Billy Fink | May 27, 2014

If it feels like there have been more sponsor-to-sponsor transactions this year, you'd be right. While these deals have always been a viable exit strategy, they are rising to new levels of popularity.

"Preliminary data from the first quarter of 2014 show about 45% of PE exits coming from secondary buyouts," writes Devin Matthews in a recent article. The frequency is a notable increase from the 41% from 2011 – 2013 and the estimated 36% pre-2008.

THE SLOWDOWN IN OTHER EXIT CHANNELS

The recent spike in secondary buyouts is likely a reaction to dissatisfaction with the public markets. Although IPOs were a preferred exit strategy just a few months ago, a dismal week of flotations in early April caused many PE firms to reconsider the strategy. In that week, 8 of the 10 IPOs debuted below their expected range — the worst performance since 2004.

Fearing that the public markets could not offer desired returns, sellers turned to their other primary options: strategics or secondary buyouts. While PE firms often prefer to sell to strategics, the current environment — high dry powder, low deal flow, low interest rates, and pressure to exit portfolio companies — has made sponsor-to-sponsor transactions a very appealing alternative.

CAUTIOUS LPs

Although secondary deals may be on the rise, not everyone is happy about it. "The surge in secondary deals is generally a good thing for GPs, but not necessarily so for LPs," writes Luisa Beltran in her article.

For LPs, a sponsor-to-sponsor transaction may offer no benefit. Jeff Golman explained, "Many of the [LPs] are in both buyer's and seller's funds, therefore, they don't get liquidity and end up investing in the same company at a higher price."

LPs find this situation particularly troubling when there is doubt that the second sponsor will be able to grow the business further. Golman continued, "Often, the private equity seller has wrung whatever savings and efficiencies out of the company

that they could under their ownership, leaving less juice for the buyer." If the second sponsor is unable to grow the business sufficiently, the only takeaway for the LP is additional fees and prolonged capital illiquidity.

GOOD FOR LOWER MIDDLE MARKET

LPs, however, tend to be more open to these flips when the deal involves two differently-sized sponsors — like a lower middle market firm selling to a larger firm.

LPs, however, tend to be more open to these flips when the deal involves two differently-sized sponsors — like a lower middle market firm selling to a larger firm. As one LP commented,

"The first sponsor professionalizes the business and grows it to a 'decent size' before selling." Not only are larger firms hungry for deals, ones that have already had institutional presence are likely to have fewer skeletons in the closet or hair on the deal.

The current popularity of these 'upward sells' is favorable for lower middle market firms. As smaller firms partner with exiting business owners, they can help professionalize the business without extracting all of its growth potential. Since larger firms are clamoring for the deals, the business could be transitioned at a healthy valuation.

Tim Shanley, of Huron-backed Victoria Fine Foods, confirmed the benefits of these small-to-large secondary deals during one of our recent events. At the discussion, Shanley explained that the sponsor-to-sponsor transaction can be particularly valuable for the operating company if the company is sold to a more experienced sponsor. In addition to their experience, larger firms are able to write larger checks to further accelerate the growth of the company.

He cited the the franchise industry as

a prime example; newer private equity firms will purchase regional stores to bring them to the national level. Upon exit, once that next level is reached, the more experienced players have developed an interest and can take the company even further — aiming for a strategic exit at the end of their 5-7 year window.

Deal Professionals, Dealmaker Outlook,
Fundraising & IR

What the SEC's No-Action Letter Means for M&A Brokers

Matt Catalano | March 25, 2014

On January 31, 2014, the Securities and Exchange Commission issued a no-action letter, providing “M&A Brokers” relief from broker-dealer registration requirements in limited circumstances.

In other words, the SEC will not recommend enforcement action against unregistered brokers that facilitate a securities transaction, involving the transfer of control of a privately-held company “to a buyer that will actively operate the company,” as long as certain conditions are met.

The no-action letter brings clarity and legitimacy to an industry and profession long hampered by uncertainty and impractical interpretive guidance – finally, making clear the activities in which unregistered brokers may engage in.

To bypass the registration, M&A brokers must abide by a certain set of conditions. One of the most critical conditions is that the buyer(s) “will, upon

completion of the M&A Transaction, control and actively operate the company or the business conducted with the assets of the business.”

Accordingly, M&A Brokers must evaluate each transaction on this two-part test – does the buyer have control, and is that exercised through active management of the company? The SEC provides further guidance – control is presumed if the buyer “has the right to vote 25% or more of a class of voting securities.”

As long as these conditions are met, unregistered brokers may:

- represent both buyers and sellers of private companies
- advertise the business
- negotiate the transaction, and
- receive transaction-based compensation without any limitation as to the size of the transaction.

This emphasis on control and active owners underscores the intent of the SEC’s no-action letter – to offer relief when a buyer is not a passive investor and in need of the protection broker-dealer registration is intended to provide. Active owners will protect themselves by learning about the target through due diligence, and, therefore, are not as susceptible to questionable solicitation tactics and conflicts of interest that originally created the regulation.

The SEC’s no-action letter also represents a shifting mindset that may serve as a harbinger of things to come in private M&A securities regulation. First, it is an acknowledgment by the SEC that not all securities

transactions are created equal, and neither are all intermediaries. Different protections are required along the spectrum of financial transactions, especially when different financial players are involved. Second, it marks a move away from the SEC’s historical focus on transaction-based compensation as the hallmark indicator of broker registration.

Together, there is a reasonable basis to believe the SEC might provide future relief from broker-dealer registration for private equity fund sponsors that receive transaction-based fees for facilitating securities transactions for their portfolio companies.

Such a relief from the costly registration requirements should bolster middle market and lower-middle market M&A. Eliminating these costs, historically passed onto buyers and sellers of companies, will unlock value in transactions and promote a more efficient flow of capital. And, an increase in compliance will decrease the legal risks associated with unregistered brokers illegally facilitating securities transactions.

In the meantime, on Capitol Hill, the United States Congress is having a conversation about simplifying registration requirements for M&A Brokers. On January 14, 2014, the House unanimously passed H.R. 2274 to amend the Securities Exchange Act of 1934, and the same version of that bill is now in the Senate Banking, Housing, and Urban Affairs Committee.

The SEC interprets the laws of Congress, and until a bill is passed into law, the no-action letter serves as interpretive guidance, effectively granting

The SEC’s no-action letter also represents a shifting mindset that may serve as a harbinger of things to come in private M&A securities regulation.

M&A Brokers relief from broker-dealer registration, subject to the conditions therein.

It is important to note, that M&A Brokers should proceed with caution – relief is transaction-based and state regulations will still apply.

Deal Professionals, Dealmaker Outlook, Regulatory/Legal

Why the Traditional Search Fund Model is Changing

By Billy Fink | March 19, 2014

In recent years, the traditional search fund model has begun to evolve to address some of the common concerns — namely around lack of experience and lack of committed capital.

To learn more about these developments, we spoke with Professors Yudkoff and Ruback of Harvard Business School and Kousha Bautista-Saeyan of Long Trail Leadership.

A GROWING NUMBER OF SEARCHERS

Although the search fund community is still relatively small, it has been growing in popularity. “An increasing number of talented, young businesspeople are being drawn to the idea of acquiring smaller firms and then running them as CEO,” explained Professor Royce Yudkoff of Harvard Business School. “Here at HBS, the number of people taking courses on this subject is up 8x over the past 3 years.”

General interest in the strategy has grown in response to many baby boomers reaching the retirement age.

“Overall, there is greater awareness among young entrepreneurs of the need for older entrepreneurs to sell their business,” explained Professor Yudkoff. “These exiting business owners need an investor that can both help them take chips off the table and take over managing the business.” Many young businesspeople are recognizing this fundamental demographic shift, and are trying to capitalize on the opportunity.

One such searcher is Kousha Bautista-Saeyan of Long Trail Leadership. “I was particularly drawn to the search fund model because it sat between the two poles of corporate life and startup life,” he explained. “While I knew I wanted to run a business, I didn’t feel comfortable shouldering the risk of creating a new company. The search fund model is less risky, but still exciting.”

AND A GROWING DIVERSITY

While these searchers are similar in their desire to run a business, they are quite diverse in their skill sets and experiences. “I am impressed by the breadth of successful patterns in our searchers,” commented Professor Richard Ruback, also of Harvard Business School. “It is not the case that any one set of experiences makes for a successful searcher — there is no one size fits all. Our searchers are usually in their 30s and have had substantial work experience, on which they are able to build in a very productive way.”

Instead of a specific professional track, the most successful searchers tend to have the same qualities that make for any successful entrepreneur. “Tenacity, energy, and interpersonal competence are three qualities that help make for a successful searcher,” Professor Yudkoff commented. “The search fund process

is endless work and one needs to be able to overcome the challenges.”

NEW STRATEGIES DEVELOPING

As young entrepreneurs adopt the search fund model in greater numbers, they are also seeking to change it. “There has been increasing diversification of the search fund model recently,” explained Bautista-Saeyan. “People are spotting inefficiencies in traditional models and are shifting appropriately.

“One of the most popular alternative models is many searchers are now seeking one or two partners that will support them with committed capital and advice, instead of going to 20 different individuals. It is a real partnership,” said Bautista-Saeyan.

Besides addressing the logistical challenges of the traditional model, this new model helps to mitigate some concerns expressed by intermediaries and business owners — namely inexperience and lack of committed capital. “The new model is appealing to searchers and business owners alike since it brings committed capital, energetic youth, and ‘gray hair’ experience to the table,” explained Bautista-Saeyan. “The combination of young searchers to run the business combined with more senior partners offers an appealing partnership.”

While many of the new searchers have adopted this partnership model, it is not easily reproducible. “While more appealing, this is a much more difficult model to replicate since you have to find one or two HNWIs that trust and believe in the searcher,” said Bautista-Saeyan. “The cost to each investor is significantly higher, since the risk and capital are not diversified, but the likelihood of success is higher and they are more willing to offer advice.”

WHEN AND WHY TO INCLUDE A SEARCHER ON A BUYER LIST

The growing popularity and changing models has caused many intermediaries and business owners to warm up to the searcher model.

“Merger advisors are becoming more aware of the value of a searcher and look at this trend as helpful to solving some of their problems,” explained Professor Yudkoff. “When a business broker has a seller who wanted to retire from a smaller firm and sell it, they knew they would have a problem [drawing the interest of] private equity — because of the size of the business and owner wanting to leave. Searchers give more options to business brokers than they had before.”

Although the perception from intermediaries is improving, not all businesses are meant for a searcher. As Professor Ruback explained, “very large and/or overly complex businesses are not appropriate for searchers. It is hard to imagine the searcher stepping in, for example, to a business with \$100 million in revenue and being prepared to take on that management challenge. There are certain challenges [associated with] that type of business that pure energy and tenacity cannot overcome.”

However, if the business is “within the scope of an energetic, well-trained 30 year old with valuable experience” or is “in the range of \$0.5 – \$3 million in EBITDA,” the business owner should seriously consider a searcher.

Deal Professionals, Fundraising & IR, Sourcing Deals

What is an Evergreen Fund Structure?

By Billy Fink | February 25, 2014

Traditional PE funds have been losing some luster in recent years. High management fees, illiquidity of the LPs’ investment, and the strategy of selling the best companies earliest have left many investors frustrated with the standard fund protocol.

As a result, there has been a lot of conversation around how funds will evolve from the standard 2-20 fees. One strategy that has generated significant attention is the evergreen fund structure (aka permanent capital PE vehicles).

“In an evergreen fund structure, the fund has an indefinite fund life,” explained Axial Member Mason Myers of Greybull Stewardship. “Every couple of years — typically four — LPs have the ability to exit or to change their investment in the fund. At the end of the four years, the portfolio is valued and some carry incentive is calculated for the GPs.”

Evergreen funds are becoming more popular because they help alleviate two of the major complaints among LPs: expensive management fees and illiquid investments.

ONE MANAGEMENT FEE

Myers explained, “one of the most obvious benefits [of evergreen funds] is the one management fee.” In traditional firms with multiple funds, there can be layers of management fees, creating an expensive experience for the LP.

Alternatively, evergreen funds have, “just one fund with one management fee, making it more manageable, more transparent, and a good advantage for LPs,” explained Myers. While the newer fund structure doesn’t eliminate the management fee, it greatly reduces the layers of tension.

IMPROVED LIQUIDITY

Evergreen funds also satisfy some LPs because of the improved liquidity mechanism. “Because there is liquidity every four years, it is easier for LPs to adjust commitments,” said Myers. While LPs should plan to invest for more than one four-year cycle, the flexibility is reassuring to many.

Still, the model doesn’t offer perfect liquidity — these are private companies, after all. “The biggest challenge [for evergreen funds] is valuing the portfolio at four-year intervals,” explained Myers. “Without a buyer writing a check, valuing private companies can be imperfect.” This challenge makes it difficult for LPs to predict exactly how much money they will see in return.

Evergreen funds are becoming more popular because they help alleviate two of the major complaints among LPs: expensive management fees and illiquid investments.

Additionally, there are challenges associated with returning deployed capital mid-investment. If, for example, many LPs decided to call their capital at the end of one four-year cycle, the

GPs would be in a very difficult situation. However, most payouts can be handled through company profits, other LP buy-ins, and notification clauses in the contract.

This general uncertainty, combined with the novelty of the structure, has caused wariness in some LPs.

BUSINESS OWNER FOCUS

Many LPs overlook this wariness for the biggest benefit of the evergreen structure: total focus on the portfolio company. This focus allows GPs to build a more trusted relationship with the business owner and drive growth, instead of IRR. "In a traditional structure, you may be motivated to sell soon so your IRR looks good, so you can raise a second fund," explained Myers. "Those sort of types of pressures are lesser in evergreen fund structures. Because evergreen structures have no specific time frames, the business owner can set the growth rate and business strategy that is best for the business, not necessarily a strategy imposed by fund level restrictions."

He continued, "The longer-term focus of the fund removes a lot of the pressure to put money to work and exit investments based on motivations or limitations at fund level."

Ashby Monk, executive director of the Global Projects Center at Stanford University, sees the similar importance of the fund. He wrote, "the GP can focus like a laser on value creation over the long-term and not worry about 'exits'; 'bankers'; 'timelines'; etc. This should prevent rent seeking and financial gearing, while reducing costs." He continued, "I think it's got legs. And I know quite a few people on the LP side agree with me."

BUT... REMAINING NICHE

Despite the generally positive reception to — and performance of — evergreen funds, Myers does not believe they will become the primary

PE structure. "Fixed term funds will probably always be a common structure because they work well in many situations," he said. "However, I do think there is becoming a lot more diversification in fund structures and strategies — which allows companies to find capital sources that are best aligned with their needs."

Myers concluded, "Evergreen funds will continue to grow as LPs and business owners alike look for new strategies that are better for certain companies. And, I expect there will be other structures that people conceive of over time. As the market becomes more diverse, fluid, and larger, there will be more sources of capital for business owners which is a good outcome."

Client Acquisition, Deal Professionals, Fundraising & IR, Future of Capital Markets

Mezz has largely been forced into a corner by PE firms chasing returns and unitranche lenders rising in prominence. To counter the squeeze, many mezz firms have already dropped warrants from their agreements or lowered their return goals — but with little success.

The two primary challenges facing mezzanine right now are the rise in unitranche lending and the focus on returns.

The two primary challenges facing mezzanine right now are the rise in unitranche lending and the focus on returns.

THE RISE OF UNITRANCHE LENDING

One of the biggest threats to mezzanine right now is unitranche lending, the strategy of combining senior and subordinated debt into one package with a blended interest rate. As Burkhart explained, "The success of unitranche lending...has continued and has now moved into the lower middle market." While it can be a little more expensive than traditional mezz, this more complete package has become more appealing for both lenders and borrowers alike.

The rise of unitranche lending has been particularly important in the lower middle market. "Unitranche is generally more useful for smaller deals, because the strategy is not suitable for broadly syndicated loans," explained Steven Bills in a recent *Buyouts* article.

Bills noted, "the emergence of unitranche financing has put additional pressure on mezzanine...Unlike conventional senior-subordinated capital arrangements, lenders can present unitranche deals to borrowers at a single, blended interest rate...while eliminating the inter-creditor agreements that can cause difficulties in bringing a deal to close."

Two Trends Shaping the Future of Mezzanine

By Billy Fink | February 18, 2014

Despite the overall popularity, mezzanine financing has been experiencing some trouble recently. The strategy that thrived in the hot buyout market has struggled to maintain its relevance in today's cooler conditions. "Overall, traditional mezzanine is in a tough spot right now," explained Joe Burkhart of Saratoga Investment Corp.

CHASING RETURNS

The lackluster M&A activity in recent years has impacted the decisions of many business owners and investors, especially with regards to valuations.

The desire to make up returns — amidst a relatively cold market — has caused many equity investors to blur the traditional debt-equity line.

As Burkhart explained, many mezzanine lenders are getting squeezed as PE shops begin moving into the smaller markets. “The pressure PE sponsors have to deploy their capital in a low volume market,” is causing them to “write larger equity checks which closes the gap between the senior debt and the equity — where traditional mezzanine usually exists.”

Bills also noted the impact of the returns picture. “In the past, subordinated debt promised investor returns in the mid-to upper teens, while returns from private equity sponsors approached 30 percent. Today, top-quartile equity returns are more like 20 percent, so that the kinds of returns once delivered by mezzanine are now going to the equity part of the capital stack.”

LEARNING TO SURVIVE

As traditional mezz shops get squeezed by this unintentional pincer attack, they will need to adapt. Burkhart believes that one of the best solutions would be for these mezz shops to move away from pure lending, a strategy which he is already seeing. “Many traditional mezz shops are evolving into more growth-oriented investors,” he explained. “They are structuring their investments as debt with a significant equity component and the use of proceeds will be for growth purposes. This investment style requires different skill sets, has more risk, but has better upside for the investor.”

John Thornton of Tregaron Capital agreed. “If you want to do mezz in the lower middle market, you have to be willing to get skin in the game,” he said. “Even though it is structured as debt, the risk is much more like equity. Because they are tiny companies, the risk return is such that you need to do work. There are generally better returns, but more risk because they are smaller, more fragile companies.”

Thornton is versed in this strategy because Tregaron has jointly issued mezz and equity in several of its own deals. He explained, “For control deals, we typically provide both the equity and the mezz debt. Since these are typically small companies and small deals, there are not many third party mezz players out there that would be interested, so providing all the required junior capital is the only way to get deals done.”

Still, it’s important to note that mezzanine isn’t going away. Ronald Kahn of Lincoln International explained those best suited for mezz loans are, “The highest quality deals backed by well-capitalized, well-known sponsors. Because these are the most sought after financings, senior lenders are eager to lend to these credits, making it easier to club up the number of lenders needed to complete the financing, while the increased competition among lenders tends to result in more favorable terms for a borrower.”

Deal Professionals, Dealmaker Outlook,
Sourcing Deals

Zombie Funds: How the SEC is Arming Itself Against the Undead

By Cameron Cook | AccuVal-LiquiTec
September 9, 2014

Private equity funds can produce good returns, but some inevitably will not. And some, too, will become illiquid. Enter the zombie fund, a private equity fund (or hedge or venture-capital fund) that contains hard-to-value illiquid investments that have gone bad and lingered beyond the funds’ targeted lifespan. Zombie funds often have stale valuations that foster the reporting of much higher values than current fair-value measurement would produce.

Prequin data, reported in June 2013, indicated there were 1,200 zombie funds with \$116 billion of assets in funds that had reached the end of their expected holding period and had no successor fund planned. And the original value of the investments tied up was far greater than that. The number of zombie funds is likely to rise over the next several years, as older funds with non-performing assets reach the end of their original expected holding periods.

The greater prevalence of these funds can threaten private equity standing with both regulators and LPs alike.

WHERE ARE THE ZOMBIE FUNDS?

Zombie funds are typically older and at the end of their expected holding periods. They should be put to rest, but the higher stale valuation of fund assets and attached investor agreements keep these ill funds alive. Because of the assets' illiquidity and the investment terms, investors are locked into these funds, which continue to accrue management fees without a strong likelihood of a future payoff. If the assets in question were immediately sold, then the market would likely pay a lower value than the value being reported, and the funds, as well as their investors, would recognize significant losses.

Consider this example: A private equity fund with an expected term of 10 years made a \$500 million investment in several Internet-related start-up companies in 2000. The start-up ventures, along with several other investments the fund held, proved disappointing. Reporting states that the investment in these companies is now worth \$100 million, but this figure is based on a valuation analysis of the businesses that was performed internally two years ago. It turns out that the real fair value measurement exit price is likely less than \$1 million. Even though the fund is nearly dead, the higher valuation being reported and the terms of the original agreement means that investors will pay higher fees for a longer period of time than should be warranted.

Investors complain that the unrealistically high values on these underperforming, hard-to-sell assets produce inappropriate fees charged well beyond the investors' originally intended holding period. For pension funds, these stale (higher than fair value) figures can affect management fees, prevent an accurate valuation of funds available for paying retiree benefits and tie up resources that could be invested elsewhere.

HOW THE SEC IS ARMING ITSELF

The SEC has become increasingly aware of this situation as pension funds have increased their investments in such alternative asset classes, and

they are beginning to take action. Bruce Karpati, chief of the SEC Enforcement Division's Asset Management Unit explained at the Private Equity International Conference in 2013, "To launch this initiative, we used data about funds' portfolios

The SEC has become increasingly aware of this situation as pension funds have increased their investments in such alternative asset classes, and they are beginning to take action.

and looked for funds with unusually low liquidity compared to their peers. In examinations and investigations of the target funds, we look for misappropriation from portfolio companies, fraudulent valuations, lies told about the portfolio in order to cause investors to grant extensions, unusual fees, principal transactions, as well as other situations that concerned us. We think the zombie manager issue is significant and given the large amount of capital raised in 2006 and 2007, will likely become more important when those vintages reach maturity."

It is clear that overvaluing assets could prove problematic for fund managers if the SEC does not find the proper documentation to support the reported figures.

HOW TO PREPARE YOURSELF: PROFESSIONAL, UNBIASED VALUATIONS CAN HELP

As the private equity industry has evolved, so have the valuation standards and accounting guidance available. Most newer limited-partner agreements (LPAs) establishing a private equity fund now require firms to provide quarterly and annual financial statements using Generally Accepted Accounting Principles (GAAP). These principles require financial statements to report the fair-value measurement of portfolio positions, using fair value as defined in Accounting Standards Codification (ASC) 820 – Fair Value Measurement. Depending on the conditions, auditors often require valuations of hard-to-value assets held by private equity funds to be performed by independent valuation professional.

Engaging an independent valuation firm helps avoid management biases while encouraging consistency, professionalism, due-diligence practices and depth of analysis. This naturally benefits investors, but it benefits private equity firms as well. Beyond averting the gaze of the SEC, this type of reporting helps build the reputation of the fund manager, creating a fundraising competitive advantage during the next round. On the other hand, firms known for holding and charging ongoing management fees on zombie funds will face increased difficulty raising capital in future cycles as the misalignment of fund manager and investor interests becomes clear. Using a professional firm also can help management in the audit process, reducing audit time and expenses.

In addition, regular professional valuations can help address other potential problems. Without strong valuation procedures:

- A fund's net asset value could be inaccurate
- Large swings in net asset values could occur unnecessarily due to the sudden updating of stagnant valuations
- Poor internally prepared valuations and valuation practices could lead to litigation from investors and stakeholders
- Auditors might provide a qualified opinion to financial statements or refuse to issue financial statements altogether
- Institutional limited partners in private equity groups (those that need to produce GAAP-based financial statements), such as pension funds, investments funds and endowments, could not offer timely accurate performance reports to their boards, investors or beneficiaries

More frequent, independent fair value measurements are one of the tools needed to avoid zombie funds and the SEC examination and reputational damage they cause. As industry regulations increase and scrutiny continues, best-in-class firms will engage the expertise of independent, third-party professionals to analyze the hard-to-value assets, helping prevent a financial fright.

Deal Professionals, Dealmaker Outlook,
Fundraising & IR, Post-Transaction, Regulatory/
Legal



3 Methods for Valuing Your Business

By Jaime Raczka | January 21, 2014

You've decided to sell your business, and one of the things on the top of your mind is naturally valuation. You've hired a banker or advisor and they've come back with an estimated valuation range that just isn't what you were expecting. So how did your bankers arrive at their unsatisfactorily low conclusion – isn't valuation as simple as applying a relevant revenue, EBITDA, or free cash-flow multiple to your business?

While multiples are a common shortcut for valuation, conducting a thorough valuation is much more complex than slapping a multiple on an income statement line item. Determining the value of a business can be an opaque and somewhat subjective process. So, how exactly, then, does a banker go about approximating what a business is really worth?

Any banker worth her salt is going to start a valuation exercise by utilizing multiple methods to narrow in on the right number range. There's more than one way to value a company, and no one method is more accurate than any other. While intuitively it makes sense that all valuation paths lead to the same end result, the reality is that once the numbers have been crunched, a banker is most likely going to end up with a handful of independent, estimated values for a business.

Here's where the real work begins: looking carefully at the ranges of valuation that your different methods have produced and using qualitative, subjective insight to distill your various valuation estimates into a single range that makes sense. For each method of valuation, a banker is going to consider

a variety of non-quantitative factors and adjust the valuation accordingly.

Let's look at some of the primary considerations a banker will review when it comes to some of the most common valuation methodologies:

DISCOUNTED CASH FLOW (DCF)

If bankers had a crystal ball into the future, DCFs would be a great way to value a business. Instead, DCFs involve a huge amount of discretion in projecting what a company's business will look like for the next 5-10 years. Operational assumptions for the model are typically provided by a company's management team, so a banker needs to consider that the validity of the data (and therefore the valuation) will heavily rely on management's ability to accurately predict the future.

Most buyers, as they start to negotiate with you, are going to attack many of the assumptions you've made about future growth. By helping your banker understand which line items are highly predictable and which you believe are more variable, you'll be able to get a better valuation for your business and help them in negotiation with a buyer.

TRADING COMPARABLES

Most bankers typically love using trading comp multiples to determine

valuation because they reflect real-time, real-world valuation data. The key consideration for utilizing trading comp valuation is to make sure you have the right universe of peer companies – which companies are the closest reflection to you in terms of size, product mix, growth potential, etc. Bankers will ideally look at a peer group of somewhere between 5-15 businesses, but in addition to simply looking at the group average, a smart banker will focus on the companies that look most like your business, and consider these companies' multiples more heavily than the group's average. Helping your banker understand the key differences between the peer group and your firm can help her understand which companies are most relevant and will have the biggest impact on the valuation of your business.

TRANSACTION COMPARABLES

Using transaction comps are hit-or-miss as a method for reliable valuation. The challenge with transaction comps is that there are likely a limited number (if any) of truly comparable transactions for a banker to consider. Assuming a banker is able to compile a list of transactions that make sense, the data surrounding the transaction (such as purchase price) is rarely publicly available. And when

it is, a banker isn't going to know what portion of the price paid was standalone valuation and what portion was attributable to other factors (synergies, control premiums, etc.). And finally, recency matters – market conditions, industries, etc. change. So, depending on what's available, transaction comps can run the gamut from being virtually ignored in a valuation process to being a lynchpin in a negotiation of value. Often, as an industry insider, you'll have information about recent company acquisitions that your banker isn't aware of or doesn't know much about. By filling her in with more details, she can build a more realistic model for your business.

Your banker has now run all the numbers, made the necessary adjustments, and hopefully determined a valuation range. If it sounds like conducting a valuation isn't quite as formulaic as you might have thought, that's because it's not. No valuation method will ever truly account for all the unique attributes and idiosyncrasies of a business. The best a banker can do is account for as many variables as possible and settle on a range that makes the most sense. By staying involved in the process and providing information your banker may not have access to you can ensure you're getting the most realistic valuation range.

And, though your banker is going to do their best analysis to predict an accurate valuation range for your company, remember that valuation is never perfect and that the only true way to find out the value of your business at any given point in time is to approach the market of potential buyers completely comprehensively with an excellent presentation of your business. That is the one final say on your company's valuation — the price that the market of buyers is willing to pay.

Business Owners, Valuation

The Widening Valuation Gap

By Billy Fink | January 29, 2014

"In March 2013, I wrote that we should see record valuations in 2013 — and, in fact, we did," said John Slater of FOCUS Bankers.

Indeed, the high valuations of late have been noteworthy. However, while valuations have been on the rise, certain companies — especially the high-quality ones — have benefited from bubble-like valuations. As Slater explained, "The very good companies are routinely seeing north of 10x EBITDA."

The reason for the exponential rise is the overarching focus on returns. While better companies have always been able to fetch better multiples, the desire to make up lost yield has driven investors to offer higher and higher valuations.

"The market bifurcated itself in 2008 and 2009," Rick Schmitt of AccuVal explained. "On the one hand, businesses which have a solid business plan that is scalable model and/or produce a product with limited distribution, and less competition are more highly desired. In this type of company private equity funds can take these business, put in additional capital, and quickly grows sales and profits."

This ability to quickly scale the business with little additional work is appealing to any GP concerned about his IRR. As John Carvalho of Stone Oak Capital explained, "PE firms are willing to really overpay for a business that fits their model because they know they can make the returns on the back end. Since there is so much concern about yield, a business that can deliver solid returns is worth a high price."

Schmitt continued, "On the other hand, there is still a broad base of companies

that are over-leveraged and struggling with significant competition. Those companies have not seen the same increases in valuation multiples because there is some basic deficiency with the company." Since these companies require significant overhaul, and are less certain to deliver solid IRR, financial sponsors are not willing to pay as much. Schmitt believes these companies can still be bought for 5-7x EBITDA.

As long as investors are seeking high IRR, they will be willing to pay high valuations. Although these premium valuations are already at near-record levels, they could continue rising in 2014 if...

...CAPITAL REMAINS CHEAP AND INTEREST RATES STAY LOW

One of the most critical factors buoying high valuations has been cheap cash. "There is a twofold factor driving valuations," explained Schmitt. "One is the low cost of debt which has been stable and broadly available and the banks' aggressive desire to grow their commercial loan portfolios has been beneficial to the M&A market." He continued, "The second is the high supply of money available to buyers. The money for leveraging good companies is coming cheap and there is a lot of competition in order to fund deals. When you see WACC being influenced by the lower cost of debt, it helps to justify high multiples." Given that PE firms now have \$1 trillion in dry powder, paying high price tags is easier.

However, any changes to interest rates could rapidly deflate valuations. As Slater remarked, "once interest rates go up, valuations will fall." But, that won't likely happen this year. "Right now," explained Slater, "the predominance of analysis says that we are in a deflationary period and interest rates will probably stay somewhere near where they are."

Schmitt agreed, "Many of the banks we work with are projecting that interest rates will remain stagnant for 2014."

...STOCKS CONTINUE TO RISE

Although the stock market has dipped in the past several days, the general growth over the past year has helped encourage higher valuations. As Schmitt explained, "The investment world looks to the publicly traded marketplace to guide them for what is anticipated for growth in industries and the relative market returns. With the increased indices in the S&P and NASDAQ, the buyers have a guideline supporting higher multiples for the M&A market." As the stock market continues to rise, comparables will also rise as well, helping to naturally raise valuations.

...STRATEGICS COME OUT TO PLAY

Despite their cash-laden balance sheets, strategics have been relatively inactive recently. "The part that we don't yet understand is why there isn't greater demand from strategics," explained Slater. "In a slow growth economy, these strategic acquirers need acquisitions to grow, and it doesn't make sense that they are not more active."

Corporate development offices may look to capitalize on the extra cash by acquisitions that immediately add to the bottom line. While the results of our Corporate Development Survey revealed that 43% of corporate acquisitions are driven by accretion or synergies, the recent rise in stock prices may also spur many companies to make acquisitions simply on the basis of multiple arbitrage.

As Carl Shapiro mentioned in his New York Times article, "...deals occur when corporate profits are high and the stock market is feeling bullish: corporate executives seem unable to resist going on a shopping spree when their stock is soaring and they have lots of cash on hand."

Business Owners, Deal Professionals, Valuation

How to Improve the Value of Your Company Without Borrowing a Dime

By Gary Ampulski | Midwest Genesis
October 7, 2014

Business owners can improve the value of their companies without any outside investors, according to a study conducted over the last two years on business value creation. The study derives results from consideration of industry benchmarks and a Private Capital Market valuation model applied to data gathered over the last two years. The model is based on input from over 835 privately held business owners who have received written offers for their companies during this period.

The study helps conclude that there are four different levels of privately-held companies. Those with: Below Average Profit, Average Profit, Above Average Growth/Profit, and Low Risk Companies. These factors – and the company's industry, size, growth, and risk – are all primary drivers of valuation. While valuation is a function of profitability, the valuation multiple is relatively independent of profit or profit margin and the valuation multiple is most influenced by the company's investment risk more than anything else.

The real opportunity for an owner is to move up the value chain from one level to another. Moving from an Average

Profit company to a Profit Leader improves value by 2.7X and becoming a Value Leader by another 2.2X for a combined improvement of 4.9X.

MOVING UP THE CHAIN

So how does an owner move up the value scale from being an average company, to a Profit Leader, and ultimately to a Value Leader? How long does it take and what kind of Investment is involved?

Going from an Average company to a Profit Leader. In general, there are four major factors that contribute to achieving profit leadership (defined as having margins in the top quartile of the industry):

- Optimizing product and customer mix
- Continuous Cost Reduction
- Customer value based pricing
- Business Process Optimization

Most business owners appreciate the benefits of continuous improvement with the first three items. But the kinds of improvement that a good Business Process Optimization effort can produce over a two-year period can significantly impact Total Cycle time in the Order-to-Cash process, New Product Time to Market, Delivery Lead Times, Operational Productivity, Revenue Increase, Defects, and Margin.

Becoming a Value Leader. The last step in the value enhancement process for an owner is focusing on those things that impact value in the eyes of a potential buyer. While size and profitability are important, other factors need to be considered as well. An investor must consider the risks involved in creating a stream of profits that can be counted on to generate an acceptable return on what is invested. Investors have lots of options for where to put their money and the attention is going to be on the places that provide the best return for the least risk.

Reducing the risks involved with generating a future stream of profits for a privately held lower middle market company is what gives rise to valuation multiples that take a Profit Leader from a 3X multiple of operating income to a Value Leader with a 5X multiple.

Most investment models consider at least eight areas that contribute to becoming a Value Leader. Each area has a number of additional dimensions and levels that give it character and better definition. The study shows how the sensitivity of an acquisition model applied to the manufacturing industry can improve value. The model considers the risks of a private company investment as a key component. The value model used in this study includes variability around 25 different components contained in eight major categories including: Financial performance, Growth & Scalability, Concentration Issues, Asset Management, Recurring Revenue, Competitive Barriers, Customer Satisfaction, and Management Strength.

The results show that Valuation Multiples for Average Private Companies range from 2.5 – 3.7, 2.7 – 3.8 for high profit companies and up to 5X for high value companies.

THE BENEFIT OF BENCHMARKING

So what's important to maximizing value? With a business, Size, Growth, Cash Flow, Risk and Timing are all important. If you are a seller, nobody is going to pay for what you put into the business, they will only pay for the value they perceive they can get out of it. Even most strategic buyers have their own unique reasons for assigning value and they are often related to either the growth or cost synergies that can be extracted from the acquired business as it is integrated into the owner's existing operation. Strategic buyers may or may not share some of those synergies with the seller in the form of an increase in purchase price.

The good news is that based on the application of benchmarking, Business Process Optimization and investment modeling for lower middle market companies in the commercial print space, there is significant opportunity for owners to increase the value of their companies. If you haven't undergone a business process re-engineering evaluation effort recently it might be time see what can be gained by getting some help in this area. There are also a number of M&A professionals that can help you understand all the investment risks associated with your business today and how to minimize them in the future.

Conventional sports wisdom states that offense wins games but defense wins championships. In business when it come time to sell, profit leadership will get you a good price but a business with minimum risk will capture the ultimate premium. Doing both is "a grand slam"! Making it happen takes longer than ordering up a breakfast item at Denny's but the return is nowhere near comparable.

Business Fundamentals, Business Owners, Preparing for a Transaction

5 Key Value Drivers When Selling a Company

By James Darnell | KLH Capital August 14, 2014

Accessing the private capital markets can be tricky — especially for first time visitors. Whether you are considering a recapitalization, a management buy-in or buy-out, or a family transfer, there are key considerations that should be discussed and understood before any company is brought to market.

To identify the best buyer and maximize purchase price, the business owner and the investment banker should both be able to articulate the value drivers for the company. Clearly articulating these points can help a potential investor see the value of your business.

Below are 5 key value drivers that must be discussed as early as possible in the process so that all parties are on the same page:

1. CUSTOMERS

One of the most important value drivers to discuss is your customer. An understanding of how a business makes money and who its customers are is essential for any PE firm and deal negotiation. Too often, I see write-ups or pitch books of a business that do not explain how the business makes money. You must be able to answer that question; you have to succinctly be able to tell someone how the company makes money.

You also have to be able to speak to how you acquire customers. What is the profile and size of your customer base? How do you engage with them? Having a more organized CRM and legitimate salesforce, while not necessary for a successful deal, can help demonstrate to an interested PE firm that you are working with regular, sustainable customers.

Last, but not least, you also have to be able to speak to how you lose customers. If your customers are able to abandon your business overnight with little to no switching costs, it will be a red flag for many private equity firms. If you have customers that can leave next week without pain and heartburn, that's not a good thing. While it is not an insurmountable challenge, the deeper entrenched your business is in the customer's life and business, the better.

2. INDUSTRY & END MARKETS

In addition to your customers, it is imperative to be able to comment on

the size of addressable market. There is no need for detailed reports, but you must have a sense of the number of potential customers and trends in that space. Is your industry growing or shrinking? Is there heavy regulation? These types of extra-company factors can make realizing a successful investment difficult for most PE shops.

PE investors are also concerned about businesses that are highly discretionary. For example, if your business offers a completely discretionary item, that means the purchase can be put off during downturns and economic uncertainty. That is a big risk in future cash flows and, unsurprisingly, a red flag for many PE investors. Similarly, if a business is very cyclical, it can be challenging for an investor. Most PE firms use some form of leverage during an acquisition, and leverage and cyclical is a very risky cocktail. It can go sideways on you very quickly.

To help assuage an investor's concerns, you should demonstrate that your business tracks along with the general economy. If you can show solid financials from 2007-2010, that is a great sign that your business is not particularly subject to cyclical or customer discretion.

3. SUPPLIERS

We already discussed the addressable market and your customers, but now it is time to consider your suppliers. The two questions you need to address are:

Are there any supplier concentrations? If your business is being influenced by your supplier because of their consolidation or control of the market, that is not a deal killer, but it is something that must be disclosed to the PE firm as soon as possible. It is important to understand the costs and risks of switching suppliers.

Can a supplier go straight to your customer? If that is the case, it

makes investors very nervous. Most PE investors want to see a fundamental, tangible reason why your business exists. If you are relying on opportunistic inefficiencies, there is a great deal of risk that your business will be squeezed out by larger competitors or those with vertical integration capabilities. You need to demonstrate that your firm will be around for a long time because it is addressing a clear need — and one that no one else can easily replicate.

4. COMPETITION

As the interested investor gets the lay of the land, he will also need to know about the level and type of competition surrounding your company. You will need to effectively be able to address the presence of any competitors and how you differ from them. What are the variables? Price? Service? Location?

If there is no competition, then you still need to explain why the customer is buying from you. Are they buying from your firm because of the salesperson? Or because of the right price? It may sound like a silly question, but it is fundamental to why a company exists. The more and better you can answer the question, the more value you can demonstrate in your business.

5. MANAGEMENT & FINANCIALS

Only after understanding the full ecosystem in which your company exists will the investor begin to look into the company itself. Understanding the key stakeholders and management of the business is absolutely crucial to a successful deal.

Getting deals done in the lower middle market is so much more about the psychology of the stakeholders than actual financials. You need to make sure everybody is happy. This is why most PE firms will spend so much time getting to know the management team and making sure there is a fit. If you try and fit everyone into a predetermined box or equation, the deal will fail.

When it comes to financials, the numbers will be what they will be. At this stage of the process, the investor is probably most interested in seeing how organized your business is. The numbers need to be reliable. We don't want to be in a situation where we've made a deal, then did some diligence only to discover that we were misled. In those situations we have to break the deal, which is disappointing for everyone involved. The more confident we feel in your ability to track numbers, the more confident we will feel about the deal. However, don't worry about too many add-backs or no CFO — just be systematic with the process.

Business Owners, Dealmaker Outlook, Preparing for a Transaction

To Maximize Valuation, Look to Sustainable Top Line Growth

By Ed Marsh | Consilium Global Business Advisors October 29, 2014

Business objectives of company owners vary as much as the individuals themselves. Some seek moderate growth for stability in a 'lifestyle' business, while others pursue breakneck growth for the "rush" and satisfaction.

As companies mature, and owners age, those objectives often evolve. For every company there's a moment when the theoretical and distant prospect of a transition suddenly becomes real and immediate. Some owners carefully plan and prepare themselves and their companies in advance – others react to circumstances. Regardless of the path by which they arrived, that moment focuses participants intently and exclusively on a company's bottom line.

This focus is both understandable and natural. Most companies habitually attend to the bottom line by rigorously managing operations and costs. They often implement lean initiatives for key business processes, and managers rely on "dashboards" of financial performance metrics to flash early warnings of trends. There's a strong and common culture in American business that focuses management attention on the bottom line.

Companies grooming their financials for an impending transition have little choice – the only place to readily "move the needle" in the short term is to cut costs.

THE BOTTOM LINE IS CONNECTED TO THE TOP LINE

The "bottom line" snapshot doesn't provide much texture, but it is the inexorable sum of the top line and the costs. As such, it's an indicator. But the science of business valuation recognizes the inherent limitations of a static indicator and therefore works with a projected profit stream. In other words, it's a video compared to a single snapshot. Cutting costs is equivalent to posing the snapshot while the ongoing storyline is primarily a reflection of the top line.

The challenge for companies, whether they are embarking on a 3-5 year program preparing for a managed transition or simply bolstering resilience and vitality to increase value for current owners, is to grow the top line consistently. Doing so requires a change in business mindset.

Managers must squarely confront the dissonance that exists in common approaches to managing top line revenue growth vs. operations and bottom line cost factors. Rigor and scientific management are commonly applied to the bottom line while top line growth is managed with stale methods. Just as companies might have added another inspection station at the end of a line before they embraced operational excellence, today companies add another marketing program (e.g. SEO or social media) or another sales resource (inside rep making cold calls) to fix inconsistency in the top line.

IT'S TOO EASY TO THINK OF IT JUST AS REVENUE

The direct connection between a strong, growing top line and enterprise valuation is clear. But consistent top line growth, and the approaches that create it, have additional tangential implications to maximize valuation that are often overlooked.

1. Business owners can often substantially improve their valuation by accepting a higher "earn out" component. When that income stream is uncertain, business owners are naturally hesitant to take an earn out. But if the income stream is reasonably secure (and who knows this better than the current management) a larger earn out component shouldn't be unnerving. When revenue growth is a function of a broad, diverse and systemic effort, it's easier to "bank on."
2. Security of future revenue. Similarly, earn-out aside, a buyer will carefully consider the security of the revenue stream and the trend – not just the magnitude today. The same considerations that influence the seller will impact the buyer's comfort with future revenue.

3. The source of growth determines its profitability and repeatability. It's easy for companies to adopt tactics that will bump the top line in the short term but have consequences to sales and profitability in the longer term. Revenue growth needs to be built on strategies which create cumulative inertia and which can be clearly measured and managed for continuous improvement.

4. Diversity of revenue also impacts its value to an acquirer. Just as concentration risk incurs a discount, conversely broadly diverse top line revenue increases appeal. Diversity can be achieved across product lines, industries and geographic markets, including globally even for SMBs.
5. Global diversification not only vastly increases market opportunity size, but also provides a further layer of revenue security to the extent that markets are somewhat decoupled – economic cycles aren't directly correlated.

All growth isn't equal, as they say, and the source of revenue growth impacts its value.

MANAGING GROWTH OR RUNNING THE BUSINESS

Every manager faces the challenge of balancing competing priorities and resource constraints. Their first job is to run the business, and there's no easy answer to the question, "How do I grow in a way that strengthens my business and increases our resilience and viability?"

It's easiest to answer that first in the negative. Don't just add another rep, another trade show, another series of magazine ads, etc. Simply doing more of what isn't exceptionally effective won't make it so.

The real answer is to reengineer your revenue growth model, and there are two customer centric themes that guide successful initiatives:

- Enable buying
- Focus on the right prospects

These are deceptively complex – both in tactical execution and in the mind-shift that is required for most companies to succeed.

ENABLE BUYING

Back in the last millennium, buyers needed sales reps since they were the link to the information buyers needed in a world of asymmetric information distribution. Sales cycles were generally linear and predictable. The periodic direct contact between buyer and rep created a tempo and a series of progressive ‘yeses’, afforded the rep the opportunity to keep tabs on the buy side process and status, and allowed capable reps to sell – to influence the process.

Today buyers no longer need reps for information (except in late-stage negotiations.) And buyers who have always disliked “sales reps” now use technology not only as a proxy for reps, but to avoid them (hide behind caller ID, etc.)

There is still a critical role for a talented, creative sales person – but sales, as most companies persist in practicing it, is dead. Today the ‘secret’ to revenue growth is to help people buy. That’s tough enough if your product is a cup of coffee – it’s downright challenging if your’s is a complex sale.

The key is buyer empathy and an approach that leverages digital tools to establish thought leadership and authority. Companies can create a framework that builds relationships with buyers through a virtual sales process. It:

- Gets you found
- Establishes credibility and converts traffic to prospects
- Builds authority gradually and nurtures prospects into leads
- Supports buyer requirements, largely virtually, through their buying process to convert leads into customers
- Leverages the vast reach of digital tools to create a flow of “referrals” from leads & customers

BUILD A BUSINESS WITH THE RIGHT BUYERS

This sounds simplistic, but very few companies really execute it well. Typically companies define their targets reflexively based on historical success. That’s a self-limiting approach for several reasons:

- Industries and markets evolve – traditionally strong verticals will likely slow, and future growth will come from different areas
- Ideal buyers at one stage in a company’s growth are often less profitable during another phase
- Most companies identify target buyers and markets based on a product centric approach vs. an empathetic understanding customer business value drivers
- Traditional models tend to limit sales geographically (by region, country, continent, etc.) but today the digital reach of sales and marketing is without border, and global transactions are vastly simpler and safer

THE VALUE OF GROWTH

Not only does the old bromide that a ‘business that isn’t growing is therefore dying’ apply, but for companies preparing for a transition (and every company should be!) growth must be sustainable, predictable, and secure. That’s not

attainable by pressing harder on the accelerator of traditional approaches. Rather it takes an enlightened and bold approach to business development analogous to the revolution on operations of the last two decades – and it takes time to build. Companies that forge ahead will thrive.

Business Owners, Dealmaker Outlook, Preparing for a Transaction

Valuing Platform Companies vs. Add-Ons: The New Art of Negotiating

*By Rick Schmitt | AccuVal-LiquiTec
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Could today’s increase in “add-on” transactions mean that valuation multiples are on the rise?

Over the past few years, PE firms have been heavily involved with add-on acquisitions, rather than platform companies. (In 2012, add-on acquisitions represented approximately one half of all PE buyout activity.) With the economy on more solid footing, more businesses — including large and small privately held companies — are returning to the M&A marketplace. That means more opportunities for acquiring platforms, and broader possibilities for supporting add-ons.

At the core, these new platform/add-on dynamics are causing a shift in the art of performing business valuations, as value can differ significantly based on the viewpoint of the deal participant. This means it is more important than ever for a company to have a holistic understanding of the market.

WHAT ARE PLATFORM COMPANIES? WHAT ARE ADD-ONS?

The key characteristic of platform investments and add-ons are summarized as follows:

- **Platform** investments typically include companies in high-growth industries that command significant market share. They often are well managed, are reasonably capitalized and have broad distribution and market exposure. These companies likely have multiple avenues of growth and clear opportunities to leverage their position in the market. They typically command a premium price when sold.
- **Add-on** companies often aren't viewed as industry leaders and might suffer from issues with management, undercapitalization, lack of broad distribution or limited exposure to their industry.

Combining platform companies and add-ons through acquisitions can leverage the value of both, considering the built-in efficiencies of combination and the realization of economies of scale.

WHAT ARE THE “BUY AND BUILD” BENEFITS?

PE players seek the perfect balance between acquisitions of platform companies and value-boosting incremental add-ons. When fleshing out an offering in one industry — let's say the grocery business — it makes sense to use a key company's established name, infrastructure and management capabilities to maintain a stable presence in the market, then leverage the increases in overall value as add-on companies are acquired.

For example, the platform acquisition of Whole Foods, currently valued at \$13.9 billion, has rolled in a number of smaller add-ons, including independent grocers, a coffee maker, a vitamin brand and more. These add-ons take advantage of the platform and create synergies that help increase the sales penetration and/or decrease the operating costs for other add-ons. These synergies make both the platform and add-ons more valuable.

Keep in mind, a company might represent a platform to one buyer and an add-on to another. For example, as of the publication date, there were rumors that Whole Foods itself might be acquired by the Florida-based Publix grocery chain, valued at \$24.1 billion.

WHAT'S THE VALUE OF A BUSINESS THAT HAS DIFFERENT VALUES TO DIFFERENT BUYERS?

The simple answer: It's worth what someone is willing to pay for it.

Platforms and add-ons don't require different valuation techniques. The valuations of both types of companies use common approaches such as discounting projected cash flows at an industry rate of return, and the market approach, which compares one business to the sale of similarly sized businesses in the same industry. The difference in valuations comes in the art of estimation of the future cash flows, or the level of comparability to sales of similar companies.

It's critical to clearly understand the companies and the internal factors impacting their attractiveness to the broader market. These include sales, distribution, cost structure, management and capitalization — and the many detailed facets within each of these categories.

SYNERGIES AND SNAGS: WHAT'S IMPORTANT TO WATCH?

Analyzing possible synergies makes a critical difference when valuing add-ons. The most desirable add-ons can bring benefits like:

- Lowering costs by merging sales staff with similar expertise
- Expanding sales into regions not currently served, either domestically or internationally
- Increasing product offerings
- Cross-selling/upselling opportunities for existing products
- Eliminating duplicate management
- Consolidating financial functions, such as treasury and tax
- Eliminating idle manufacturing capacity
- Boosting buying power

In recent years, most add-on transactions have involved target companies within the lower-middle market classification, with valuations between \$5 million and \$50 million. The sluggish economy from 2010 to 2012 presented opportunities to a number of “smaller” companies that traditionally might have been overlooked by big PE firms without the benefits of an add-on. The PE firms' desire to put capital to work, along with prior platform acquisitions, made these acquisitions logical during this time period.

But generally, lower-middle market businesses haven't always had the access to capital or professional management to help them intrinsically grow. The benefits afforded by selling to a PE firm help to correct a number of issues. However, the additional costs required to repair a stagnant or troubled company can lower valuations. Some common drawbacks that affect add-on valuations include the following:

- Lack of sales distribution
- Management gaps
- IT fragmentation
- Less detailed accounting and understanding of cost structure
- HR issues, such as increased costs when merging benefit platforms
- Cost of merging operational logistics

The cost and time to fix these common issues affects the desirability and price paid for an add-on.

Since the synergies of a transaction and the associated projected cash flows may vary from buyer to buyer, the resulting valuation by a specific buyer can be different than a market consensus projection. When capitalizing a buyer-specific cash flow analysis, the results of the valuation are often referred to as the “investment value” rather than the “market value” of the business. In today’s fast-paced environment, these variations in perceived “value” are part of what buyers have to deal with when competing for the purchase of a business.

WHAT'S THE NEW ART OF NEGOTIATING?

The right platform companies generally command a premium. Competition sets the price for these companies. With growth in the M&A market and more prominent companies entering the playing field, there's no doubt we'll see more deal making — sometimes with hefty multiples paid — for major platforms. In late June, the aluminum company Alcoa announced a nearly \$3 billion acquisition of Firth Rixson (owned by Oak Hill Capital Partners), a manufacturer of jet components; Alcoa is attempting to increase its presence in the aerospace market. This is one of numerous examples of the desire to expand market share.

But valuing add-ons gets more complex, particularly when PE firms need to put capital to work and grow acquisition categories. They're able to offer higher prices, in terms of EBITDA multiples, but that doesn't always mean they will.

Imagine a lower-middle market grocer. As a standalone company, let's say the business, which generates \$6 million of EBITDA when considering all of its standalone benefits and issues, might receive a five times EBITDA multiple, or a \$30 million valuation. However, a prospective PE firm plans to roll up this company into a larger platform, so when considering the combined, projected EBITDA, that's now \$8 million. This might result in a sale that appears to be a multiple of eight times current EBITDA, increasing the value based on the trailing EBITDA and market perception of value by 33 percent.

That's where negotiating skills come into play. If there's competition to buy this grocer, then the PE firm might be forced to pay a higher multiple relative to recent transactions for similar stand-alone businesses. This converts some roll-up synergies of the buyer back to the seller, and puts more pressure on the PE firm to intrinsically grow post-merger to justify the premium.

If the PE firm chooses to pass on the deal due to the seller's request for a higher valuation, then this might mean the benefits of synergy of this potential acquisition will accrue to another PE firm that elects to complete the transaction. Ultimately, the fit with the platform and opportunity for post-merger synergistic growth represent key factors in negotiating the final value between the buyer and the seller.

WHERE ARE THE BIG OPPORTUNITIES?

Industries considered “recession-proof” are commanding heavy interest. Oil and gas. Medical and pharmaceutical. Food. Software. Most commonly, deals are sourced by investment bankers working on the buy or sell side, looking for ideal targets to maximize value.

Some PE firms search for complementary companies shortly after platform acquisitions, if there's not much work needed to stabilize the platform company. For other platform deals, the process is longer and more complex and thus delays the process of finding add-on candidates.

As for businesses, is it better to be acquired as a platform or add-on? It's situational. Platforms traditionally command a premium. But the right add-ons, though they might be smaller, may negotiate similar, higher multiples in the right circumstances.

WHAT DOES THIS MEAN FOR PE FIRMS?

Negotiations are rarely straightforward, and calculations based on synergies and costs are only becoming more complex. Is there a simple formula for choosing the right valuation for a platform or add-on? No. But understanding the total picture and the benefits of combination is key to increasing the leverage of acquisitions and overall value.

Deal Professionals, Dealmaker Outlook, Negotiation, Valuation

12 Critical Valuation Questions to Ask When Investing in Distressed Assets

By Cameron Cook | AccuVal-LiquiTec
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Valuations of underperforming businesses have peaked in recent years. While the overall process of valuing financially distressed versus healthy companies is largely the same, some modifications are needed. Private equity groups and other investors in distressed assets must be aware of these nuances when running discounted cash flow (DCF) models. Heightened focus on due diligence procedures, especially the source of financial projections, is essential.

When valuing a financially distressed business as a going concern, it is assumed the company will move forward under some plan of recovery rather than be shut down and liquidated. Under this going concern premise, the DCF method of valuation is often relied upon.

Following are 12 questions to ask during the preparation or examination of financial projections. These questions will improve understanding of risk, mitigate surprises and, ultimately, improve investments.

1. WHAT ARE THE UNDERLYING ASSUMPTIONS?

Understand the assumptions underlying the projections. Assumptions should be reasonable and well-supported. Make sure it is clear exactly how the distressed company will meet its projected revenue growth. Discuss whether projected operating profit margins are really obtainable.

2. SHOULD THE PAST BE RELIED ON AT ALL?

The company's historic performance might not be a good benchmark of how the financially distressed company can perform in the future. Be careful of projections that simply "assume" the company will reach the same levels achieved in the past. For some businesses, returning to the performance level of the prior peak may take years; for some, it will never happen.

3. ARE THE PROJECTIONS BIASED?

Studies have found that analysts who prepare projections and predict earnings more often overestimate than underestimate. This "positive bias" is common, particularly in down times when many companies simply assume they will be able to get back to where they once were. Management is expectedly optimistic. But projections need to fully consider pressures the market will apply to prevent the company from achieving projected performance targets.

4. WHAT IS THE REAL CAUSE OF THE FINANCIAL DISTRESS?

Be sure the cause of financial distress is known, understood and addressed by the company. Sometimes the economy is blamed for business decline but other contributing factors such as a permanent shift in consumer preference or the strengthening of a competitor are overlooked. Those

other factors might not go away as the economy or industry recovers. Make sure projections incorporate any changes the company needs to make in order to address the underlying causes of financial distress.

5. ARE COSTS OF DISTRESS PROPERLY REFLECTED IN THE PROJECTIONS?

Distressed companies often have extra costs that relate to or stem from financial distress. These may include but are not limited to restructuring consultant or turnaround management fees, extra legal expenses from labor litigation, severance pay or expenses from employee terminations, extra accounting expenses due to stronger reporting requirements from banks and investors and even retention bonuses to retain key personnel. Similarly, litigation and settlement costs for outstanding warranty claims, environmental liabilities and other legal disputes should be properly factored into projections.

6. ARE PROJECTED CAPITAL EXPENDITURES ADEQUATE?

In an effort to conserve cash, it is common for distressed companies to defer capital expenditures for maintenance, replacement and new development. Projections should capture the full capital expenditures needed to return the company to the level of production assumed in the forecasts.

7. IS PRODUCTION CAPACITY ADEQUATE TO MEET THE PROJECTIONS?

In a similar vein, a distressed company's plan of recovery might be to produce more of a particular new line of product or to sell more "commodity" or "standard" product, which may require increased production capacity. Further, projections often project production levels that go beyond the current capacity of the company.

Make sure projections incorporate the expansion investment required to achieve those production levels or moderate production forecasts to fit current capacity constraints.

8. IS THE PERSONNEL EXPENSE ADEQUATE TO MEET THE PROJECTIONS?

Labor, at all levels, is often reduced to a very lean level during periods of financial distress. Projections should take into account the full extent of additional production, sales and management personnel needed to support forecasted increases in production and sales. Looking at historic or industry labor hours to production ratios might test the reasonableness of labor assumptions.

9. ARE PROJECTED INVESTMENTS IN WORKING CAPITAL ADEQUATE?

The additional investment in working capital needed to support the projected business operations needs to be included in the projected cash flows used in the DCF analysis. This can be challenging, particularly in poor economic times or distressed situations. In order to increase cash flow, a distressed company might try to accelerate accounts receivable or even factor them, sell down inventory to bare levels and at the same time stretch accounts payable. This temporarily increases cash flow but sacrifices working capital levels. These reduced levels of working capital are likely not sustainable and, during the recovery period, the company will need to invest in working capital to restore a more functional level. Assumptions regarding inventory turnover, accounts receivable collection rates and the willingness of suppliers to extend terms should be realistic.

10. IS THE TIMELINE TO RECOVERY REASONABLE?

Restructuring can take time, and working through legal challenges takes management resources away from operations. The length of time needed to establish a stable level of future performance is often longer than projected. The projected timeline of recovery is most likely over optimistic.

11. ARE THE TAX ATTRIBUTES OF THE COMPANY PROPERLY PROJECTED?

Net operating losses (NOLs) can affect the projected cash flow of a company working through financial distress. The company might be able to use NOLs to offset future income tax payments, resulting in enhanced future cash flows. But the availability of NOLs and their use are dependent on several factors. The extent that NOLs can provide benefit to the distressed company being valued needs to be taken into account in the DCF analysis accordingly. Question forecasts that show tax expenses projected at a constant tax rate.

12. WHEN WERE THE PROJECTIONS CREATED RELATIVE TO THE VALUATION DATE? ARE THERE OTHER PROJECTIONS?

Projections created a significant time before the valuation date may no longer accurately reflect the expected performance of the company as of the valuation date. Make sure that projections are timely and best represent the most likely performance of the distressed company. If there are best, most-likely, and worst cast projections available perhaps a probability weighted valuation methodology is appropriate.

These questions and others can provide insight and help assess the risks of projections used in the valuation process. The risk of the

projections uncovered through this examination will help determine the appropriate discount rate applicable to the company. This match between the risk of the projections and the discount rate used is critical to an accurate valuation.

Deal Professionals, Dealmaker Outlook, Preparing for a Transaction, Valuation

