Merger & Acquisition Focus

Year End 2005

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It's in the eye of the beholder

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Ask the Advisor

Show me the money

Sources of capital to grow your business

If you're looking to grow and expand your business, several sources of capital are available — some more appropriate than others depending on the lifecycle stage, size and financial characteristics of your company. External capital (as opposed to internal capital resources such as cash flow) comes in two basic forms: equity, or selling shares in your company, and debt, which can include bank loans, corporate bonds, and leases.

Types of equity financing

When you raise capital for your business by issuing stock to new investors, you broaden your company's ownership. In exchange, you receive the funds you need to grow. These funds, however, come at a price. Paying dividends — which aren't tax deductible for business purposes — can be one cost. But if your business is young and growing rapidly, you probably won't be expected to pay shareholders' dividends right away. All companies receiving equity financing, however, experience some dilution of existing shareholders' ownership and often give up partial control over major business decisions.

Before you seek venture capital financing, understand that these investors will probably want to be consulted regarding business decisions.

When is it appropriate to seek equity financing? You may want to consider acquiring shareholders, such as angel investors, if your business is new and lenders view it as too great a lending risk. As your company grows, financing from a venture capital fund is a possibility.

Venture capitalists generally fund innovative ideas with high growth potential, and typically require a majority ownership and board positions. They particularly favor companies that are likely to go public. But before you seek venture capital financing, understand that these investors will probably want

to be consulted regarding business decisions — even if your company has a proven management team and past successes.

But progressive and promising businesses that don't urgently need capital may successfully raise venture funds without relinquishing control, especially if competing interest is created among venture capital firms.

Another equity financing option is to take your company public with an initial public offering (IPO). The net proceeds from a public stock offering can provide your company with significant capital. IPOs, however, can be expensive and time-consuming and you must be prepared to face an entirely new set of regulatory requirements by the Securities and Exchange Commission.

Debt options

Debt has several advantages: It doesn't dilute the equity of your existing shareholders, and interest payments, unlike dividends, are tax deductible. Debt financing comes in many forms with varying borrowing periods, interest rates, repayment terms and collateral requirements.

How do you know if you're a good loan candidate? Lenders look at the three C's — credit quality, cash flow and collateral. If you can satisfy their requirements in these areas, you may qualify for debt financing.

The most common type of loan is long-term, or senior debt, obtained through a bank, government-sponsored program or small business investment firm. These loans are usually obtained to pay for major purchases such as plant facilities, major equipment and real estate. The principal and interest are paid in installments, often matched to the expected life of the funded asset. Lenders typically require significant collateral for long-term loans — including physical assets, inventory and company stock.

Banks also provide short-term revolving loans with terms of up to a year. Collateral requirements are usually less stringent, typically inventory or accounts receivable.

Leasing is another common form of debt useful for buying equipment and even facilities. While leases are more expensive than bank revolvers, or credit lines — which typically cover operating expenses rather than equipment — they can be a useful supplement to bank debt.

If your company carries large inventories but doesn't qualify for senior debt, asset-based lending may be available from some banks and specialized lenders. The creditworthiness of an asset-based borrower depends largely on its cash flow and the value of its inventory. Asset-based lenders closely monitor both metrics and may terminate these loans if borrowers appear overextended.

You might also consider a subordinated debt option such as mezzanine financing, which boasts both debt and equity features and has secondary claims on assets when a company enters bankruptcy. One type of mezzanine financing, convertible debt, is a loan that converts to common or preferred stock according to a repayment schedule and within certain performance measures agreed upon by the borrower and lender. Because lender risk is higher, borrowers generally pay higher interest rates on subordinated debt than on senior debt.

Process of deploying capital

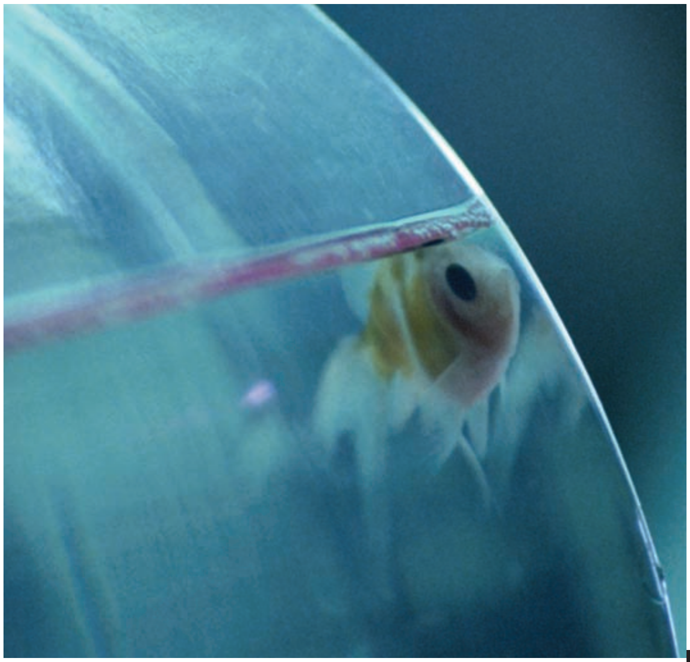
Raising and deploying capital — whether equity or debt — isn't just a transaction but a process. It doesn't end when you get the funding you need. New shareholders are likely to want to influence company strategy and, at some point, may seek dividends or dividend increases. And lenders require evidence that you are adhering to loan covenants and that your company is financially healthy enough to repay its debt.

Because you'll need to provide investors and lenders with regular financial reports, you should have some understanding of basic financial ratios and accounting concepts. This knowledge will allow you to work more effectively with your financial advisors and help you to better identify future capital requirements.

What's your business worth?

It's in the eye of the beholder

Value is relative, particularly when it comes to selling a business. The value of your company depends on many things, including the market, your goals and your buyer.



Pricing shares of a closely held business for a transfer between current owners, for example, is very different from putting a price on a business that's going to be sold to outsiders. Valuing a business for estate purposes has its own set of challenges, because of estate tax considerations.

Inside sales

Owners seeking to sell their shares in a closely held company sometimes encounter disagreements over price. Without a competitive, liquid market, shares can easily be under- or overvalued. To avoid disputes, most businesses set forth provisions for equitably pricing shares in their

shareholder agreement. Several methods can help ensure sellers aren't lowballed and buyers don't overpay.

One method is the "shotgun" clause. Under this provision, a shareholder can offer to sell for a specified price. The other shareholders have a predetermined period in which to respond to the offer and a period of time in which to complete the transaction. If the other shareholders fail to acquire the offered shares within the specified time frame, then, depending on the provisions of the shareholders' agreement, the offer period may be reset or the selling shareholder may sell to nonshareholders at market price.

Another way to avoid shareholder disagreements over price is to require specific valuation formulas. These might mean valuing shares based on a percentage of book value, revenues per share over a specific period, or a multiple of cash flow. Prohibiting the sale of stock to outside buyers and requiring the right of first refusal on shares offered to outsiders are other common clauses that tend to favor existing shareholders.

Perhaps most important, however, is a spirit of cooperation. Owners capable of appreciating fellow shareholders' point of view on valuation issues are more likely to reach compromises that preserve business stability and ultimately benefit everyone involved.

Minimizing estate taxes

While you usually seek the highest possible price when selling your company's shares, the opposite is true when you value them for estate purposes. The lower the valuation, the lower your estate taxes, and the more you potentially leave your heirs.

You'll need to hire a valuation professional to first determine your company's value and, if you have partners, the value of your interest in the business. This appraisal may include various discounts — for example, minority or lack of control discounts — that reduce its value. The IRS, however, may challenge the value you place on your shares.

Again, a shareholder agreement with a buyout clause setting the price at which other shareholders will repurchase the shares can come in handy. The IRS generally considers this price to be a fair market value for estate tax purposes. The clause reduces the chance that tax authorities or courts will assign an unreasonably high value to your shares.

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Remember context

It's important to understand that business valuation is an art *and* a science. Hiring experienced valuation professionals who understand the context of the appraisal is essential if you're going to receive the maximum benefit from your business interests.

Stock ownership plans can benefit owners, reward employees

Transferring stock of your private company to employees can accomplish a number of goals. If your objective is to sell your business, an employee stock ownership plan (ESOP) offers valuable tax and other benefits. If your aim is to reward, motivate and retain employees, restricted stock and stock options provide excellent incentives.

ESOPs

An ESOP is an employee benefit plan that invests most or all of its assets in the employer's stock. To establish an ESOP, a company sets up a trust that buys company stock and allocates it to employee accounts over time. The funds to buy the stock are contributed by the company and can be supplemented by bank loans (making it a leveraged ESOP).

Stock acquired by the ESOP is bought at fair market value, as determined by an independent appraiser. When employees retire and wish to sell their shares, the ESOP must buy them at the current fair market price.

Selling shares to an ESOP offers owners several advantages:

- The company's management and culture can be preserved — something that might not happen if the business is transferred to outsiders.
- The timing of the sale can be flexible.
- Minority shares sold to the ESOP aren't subject to a minority share discount, but are sold at fair market value.
- Morale and superior workforce productivity may increase because employees have a stake in the company.

ESOPs also offer attractive tax incentives because they're considered "qualified" plans. Companies receive tax deductions for contributing to the plan, and earnings generated by plan assets are tax-deferred. What's more, when ESOPs repay bank loans used to buy company stock, payments of both interest and principal are tax-deductible expenses.

You can benefit from a personal tax perspective as well. If you sell 30% or more of your shares in a private company to an ESOP and invest the proceeds in other U.S. operating companies, you pay no capital gains tax on the transaction. The tax basis of the stock is rolled over to the shares of the new companies.

Thus, you are able to convert an illiquid, concentrated investment into a liquid, diversified portfolio without capital gains tax exposure. If you hold the new shares until your death, they'll receive a stepped-up basis in your estate, reducing your heirs' capital gains tax.

Restricted stock

Granting restricted company stock is a good, low-risk way to compensate and reward employees and encourage them

Build the foundation for a successful ESOP

Research on Employee Stock Ownership Plans (ESOPs) by the National Center for Employee Ownership shows a positive link between employee ownership, participation, and business productivity. ESOPs can be effective tools for motivating employees and improving company performance, but management must be committed to employee ownership to make the plan work.

Actively communicating management's belief in the ESOP and management-employee cooperation help drive the message home. You can communicate your support for your company's ESOP by:

- Reporting regularly on business results,
- Including employees in shareholder meetings,
- Sharing business and financial data and teaching employees how to read and use it, and
- Publicizing "success stories" of employees whose retirement funds were bolstered by company stock.

to contribute to the company's success. Because employees awarded restricted stock must wait for a vesting period to end before they can sell, transfer or pledge the shares for loans, they have an incentive to remain with the company until the vesting period has ended. The stock may be subject to other restrictions as well, such as the price at which your company will repurchase the stock.

When employees become vested in their stock, they must pay income taxes on its market value, and your company can deduct the amount employees declare as income. Employees who believe their stock is going to rise in value over the vesting period may choose to pay taxes on the market value of the stock when it is granted. This way, they avoid paying income taxes on its appreciation during the vesting period.

Stock options

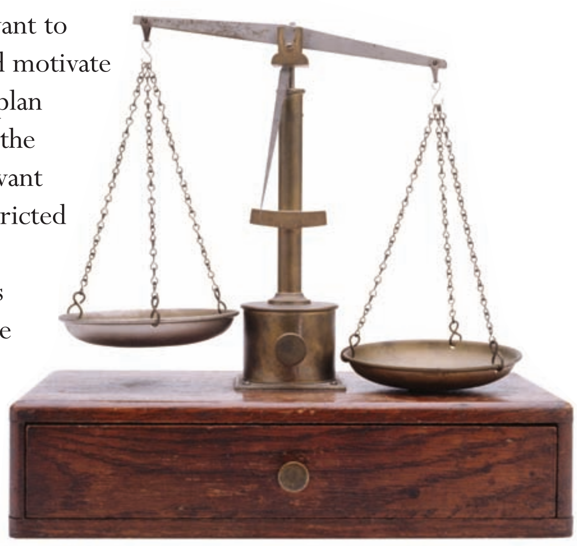
Stock options are a higher-risk incentive than restricted stock. But they may offer employees better returns — particularly when a fast-growing company may go public in the near future and the shares are likely to increase significantly in value.

A stock option provides employees with the opportunity to buy stock at a future date at a set price. Employees benefit if the market price is higher than the option price when they exercise their options. Like restricted stock, stock options typically vest over time, and the price at which an employee can sell the stock back to the company is set by a formula based on the business's financial performance. The more a company grows, the more its stock options typically will be worth. Conversely, the stock options of mature or declining companies may well prove worthless.

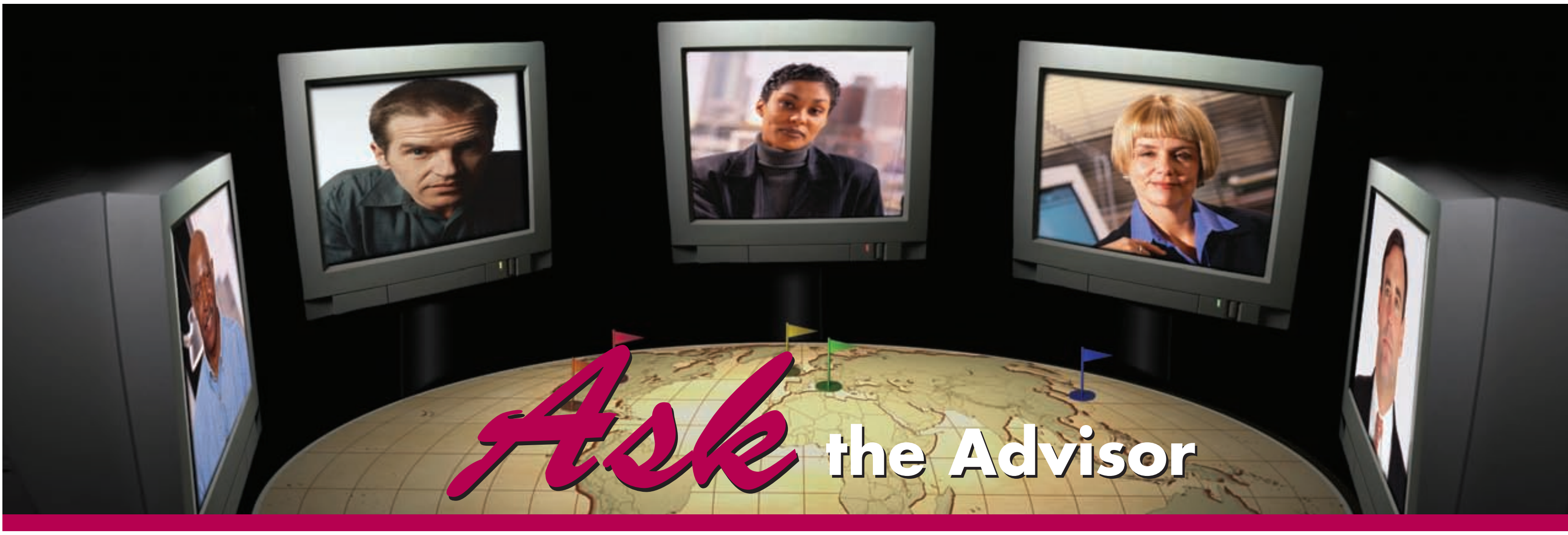
In small, rapidly growing companies on tight budgets, stock options can supplement relatively modest employee salaries. If the options expire without value, the financial cost to a company is zero, but then so is the motivational value of the options. Options are most appropriate for companies that have good growth prospects and want their employees to share in the upside without immediate tax consequences.

Weigh your options

Deciding how best to compensate and motivate employees is an important decision every business faces. The tax advantages offered by an ESOP make it an attractive choice for owners who wish to exit the business or raise capital.



Owners who want to compensate and motivate employees but plan to remain with the company may want to consider restricted stock and stock options. Factors to weigh include the financial prospects of your business, the likelihood company stock will appreciate, administrative costs associated with these programs and the ability of employees to pay income taxes for restricted stock.



Q. How is selling a C corporation different from selling an S corporation?

A. From a taxation standpoint, selling a C corporation can be very different from selling an S corporation. Calculating and comparing the incremental tax benefits and tax costs of C and S corporation transactions — as either a stock or asset sale — with the help of an experienced financial professional can reveal the optimal transaction structure.

In an asset transaction, owners sell all or most of the company's assets to a buyer and then liquidate the company stock and what few assets and liabilities remain in the business. In a stock deal, owners sell the company stock — including all the business's assets and liabilities.

For C corporation transactions, stock deals are almost always preferable to asset deals. Sellers pay tax on net capital gains from the stock only. Buyers benefit because undisclosed or contingent liabilities for the business may end up remaining with the seller, relieving buyers of unexpected debts.

With asset deals, C corporation sales are subject to double taxation. First the corporation pays taxes on gains from the sale of the assets, and then shareholders pay taxes on the after-tax amounts removed from the company.

Buyers may opt to assign the highest market values to acquired assets (known as a step-up in the tax basis) via a Section 338 election, resulting in tax benefits with an increased depreciation schedule and greater cash flow.

There are fewer tax differences between a stock sale and an asset sale for S corporation owners. This is because S corporations are considered conduit or flow-though entities by the IRS — meaning there is no federal tax on corporate profits. Instead, company profits from an asset sale flow through directly to stockholders' individual tax returns.

Therefore, double taxation generally doesn't apply unless the company has recently converted from a C corporation status. In that case, 10 years must elapse before an S corporation can be sold and treated as such for tax purposes. If the sale takes place before the 10-year anniversary, double taxation is triggered by an asset sale.

The benefit to both buyers and sellers in an S corporation transaction is the option to deem a stock sale as an asset sale under a Sec. 338(h)(10) joint election. Treating an S corporation transaction as an asset sale produces the same depreciation cash flow benefits as electing a C corporation transaction as an asset sale. S corporations, however, don't experience the same tax costs as C corporation transactions because gains and losses from the step-up flow through to shareholders.

This reduced tax burden normally makes an asset sale of an S corporation the optimal transaction structure for buyers. Also, because of the beneficial depreciation schedule for the buyer, the seller may fetch a higher sale price.

Before buying or selling a business, be sure to calculate the total tax implications of various options. Your type of business entity could very well determine whether a stock or asset sale makes more sense.