

## Foreign Acquirers: Attracted but Attractive?

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*"How does the US middle market business owner profit from selling their business to a foreign buyer with a weak dollar and in a weak economy?"*

### What's the Difference?

#### Venture Capitalist (VC)

An organization that primarily finances new or start-up businesses with rapid growth potential and little or no operational history. They play an active (interventionist) role in company decisions.

#### Private Equity Group (PEG)

An organization that primarily invests in existing companies privately (rather than on a stock market). They tend to invest for the longer term to develop new products or markets, and to make acquisitions. They are less involved in day to day company decisions, relying on existing

The weak US economy has created a compelling argument for non-US buyers to look for acquisition opportunities in the US. Is this a good thing for your business?

The value of potential acquisition targets falls when domestic strategic acquirers are reticent to buy due to their own weak earnings or the scarcity of cheap financing. That is, competition to acquire the target business wanes and consequently the target's value drops. Eventually the value falls to a point where the target begins to attract attention from more foreign buyers. This increasing interest stops the value from slipping lower and can push it back up once more buyers show interest.

The weak dollar also

comes into play. The Euro is worth 15% more in US dollars than it was 12 months ago. In other words, the same Euro buys 15% more business in the US even before you take the weak economy into account. That's fine but how does the US middle market business owner profit from selling their business to a foreign buyer with a weak dollar and in weak economy?

Foreign buyers are getting into the US cheaply with the intent of riding out the downturn and profiting from the economic up swing and the recovery of the dollar. US business processes and culture, like any other, take time to understand and navigate so foreign buyers aren't going to dismiss the skilled management that built the

target as that would just increase their risk. In fact, they're likely to require the owner-manager to stay on for a period of time as a condition of the sale.

This can give the well-advised seller a great opportunity while also lowering the buyer's risk. The owner can accept an earn-out that allows them to sell a portion of their business now and stay on as a manager to guide the business through the downturn and into the economic recovery with the help of the acquirer's capital. At a defined point in the future the owner can then cash out their remaining interest at a higher price. It can be a "win" for both buyer and seller (see "*Considerations in an Earnout*" elsewhere in this newsletter).

## PEGs Are Courting Smaller Companies

Over the last few years there has been a significant shift amongst US private equity groups (PEGs). Previously they had the luxury of being very selective and could focus on a few specific industries and set firm high revenue and EBITDA thresholds because there were plenty of big deals around. As the field has become more competitive (there are 1800 PEGs in the US) and the economy has slowed, they've become more resourceful, flexible and responsive.

This manifests itself in ways relevant to middle market businesses.

PEGs are now directly sourcing middle market deals via telephone and email campaigns so that they can: **(1)** establish early relationships with business owners in hope of being the preferred partner if a deal emerges, **(2)** see emerging deals before other PEGs do, and **(3)** see deals exclusively so that they don't have to compete for them on price and terms in an investment

banker's auction.

The more positive aspect for middle market businesses is that their investment criteria are more flexible. Most will consider profitable well-run companies in more business sectors than before. Their revenue and EBITDA thresholds have also become flexible (e.g. some that had a \$50m revenue threshold reduced that to \$25m). As sources of bank loans have dried up some PEGs are also offering loans in the form of convertible debentures (debt that can be converted to equity) to get a

*“Don’t pick targets that are too small because they can take just as much effort to acquire and integrate as will larger ones.”*



### Roll-Up in a Down Market

The Theory: (A) acquire a solid company in a fragmented industry to be your “platform” or use your own company as the platform; (B) add on more small companies in the same industry; (C) buy out the individual entrepreneurs and create a single entity; (D) gain the benefits to EBITDA that scale, lower costs and better management provide; (E) exit at a high multiple via IPO or private sale; (F) live happily ever after. *What could go wrong?*

An economic downturn does create an opportunity to acquire and grow businesses by strategic acquisition at more reasonable prices than does a booming economy. The EBITDA of the targets will be lower as will the multiples of EBITDA that the owners will expect to get as a price.

Nonetheless, you need to know where you’re going, stay focused on execution and have an exit plan.

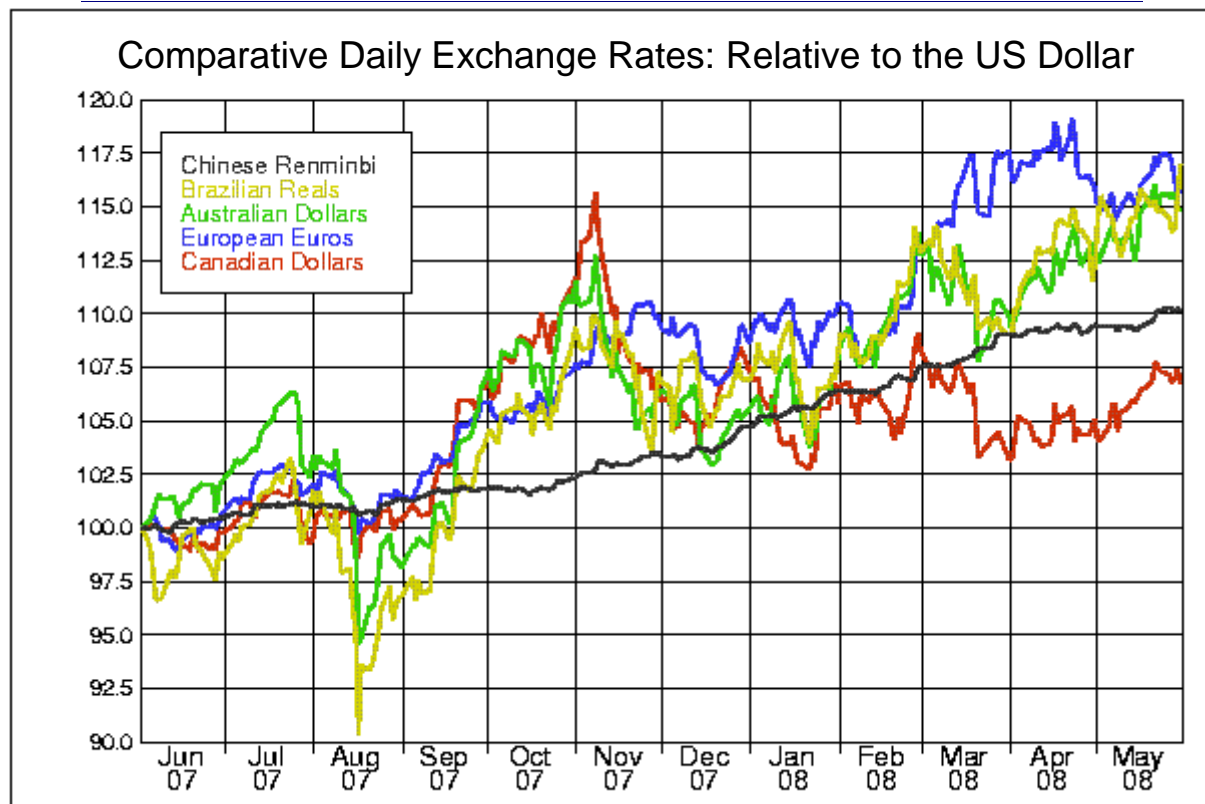
The elements of good execution are fairly obvious but worth stating: **(1)** have both a well-considered overall plan and a template for evaluating targets; **(2)** use outside professionals to help you find, evaluate, approach and negotiate with targets that fit your template in order to get the best value and terms; **(3)** don’t acquire add-on businesses for all cash or the retained owners/managers will lose motivation; **(4)** having said that, the skills it took to build the \$20 million business you just acquired may not translate to the new \$120 million business you’re creating so be prepared to pare the management ranks; **(5)**

ensure that the retained management of the targets understands and subscribes to your plan and has incentives to see it through; **(6)** ensure that systems integration is not going to be a nightmare or you’ll be blind to the timely financial data needed to run the business; **(7)** don’t pick targets that are too small because they can take just as much effort to acquire and integrate as will larger ones; **(8)** create a new management structure to run it all as one, rather than run the parts in parallel, or the benefits will be minimal; **(9)** create a board of experienced outsiders (not insiders from the acquired businesses) who know the questions to ask to keep you on track; **(10)** don’t acquire faster than you can integrate. Again, *what could go wrong?*

Source of Chart at the right: Pacific Exchange Rate Service.

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Time period shown in diagram: 1/Jun/2007 - 30/May/2008



## Smoothing the Road from *Letter of Intent* to Closing

After months of discussions you finally have a signed Letter of Intent. In it you've agreed to complete due diligence and execute a Purchase & Sale Agreement within 45 days. It's smooth sailing from here.

Maybe. Remember that both the game and the players have changed. While the negotiators of the LOI had developed rapport and trust over months that rapport does not easily transfer to the teams that will now complete the due diligence and draft the P&S: accountants, lawyers, appraisers and so on. They're paid to search for the flaws and weaknesses. Even with the best intent the

details of the deal have to be scrutinized. This creates tension but high stress is not inevitable. You can take a few steps during LOI negotiation to keep on track and preserve good will.

**First**, ensure that during LOI negotiation the buyer makes the seller aware of the focus and depth of the due diligence. Of course the financials are important but what are they valuing most: the physical assets, the IP, the customers, etc.? Knowing this, all the relevant records can be made current, complete and available to everyone via the investment banker's electronic deal room within minutes of agreement.

**Second**, try to set a tentative schedule for the parts of due diligence that require the coordination of schedules such as site visits, personnel interviews, inventory, etc. or you'll be scrambling later.

**Third**, ensure that your legal team is kept in the loop throughout the LOI negotiation. They should understand the strategy behind the LOI and how you got there. This will ensure that the draft P&S doesn't contain caveats and conditions that have already been negotiated away. This approach will cost a bit more at the front end but will help to avoid *over-lawyering* during the P&S negotiation and will ultimately save money and aggravation.

*“Avoid over-lawyering during the P&S negotiation.”*

## Considerations in an Earnout

An “earnout” is a contractual provision in a Purchase and Sale Agreement that provides that the seller of a business is to obtain a portion of the sales price in cash at closing and the remainder as future compensation based on the business achieving certain financial and other performance goals. The purpose is to tie the total price paid to a transitional period of post-sale performance.

Earnouts are common in a number of circumstances including:

- When there is a disagreement about enterprise value.
- When there is concern about loss of customers.
- When the buyer is a foreign enterprise.
- When the buyer is not from the same industry
- When the buyer is a

financial entity such as a Private Equity Group.

Earnouts are often tied to:

- Revenue/turnover
- Earnings/EBITDA
- Specific post-closing events such as regulatory approval, product launch, sales contract, etc.

An earnout can be a win for both buyer and seller if they have a well-written agreement. The buyer could have an enterprise worth more than they paid and the seller could get a big second bite at the apple (See sidebar on tax).

The definition of a well-written agreement will depend on the specific circumstances but here are a few things to consider:

**1.** The goals should be objective and measurable. That is, expressed in numbers.

**2.** The financial objectives should be based on revenue rather than EBITDA as the latter is easily manipulated.

**3.** If you must use EBITDA then clearly define what costs can and cannot be deducted to arrive at the figure (e.g. exclude accelerated lease payments or accelerated R&D).

**4.** Be sure to define when relevant revenue is booked: when a sale is made, the bill sent out or the revenue collected.

**5.** Use a sliding scale for payments rather than an all-or-nothing standard (not X% if we reach \$Y).

**6.** Ensure that there is a good employment agreement that gives the seller an active role in achieving the goals.

**7.** Define the early exit options to minimize the financial impact if you agree to part company sooner.

*“An earnout can be a win for both buyer and seller if they have a well-written agreement.”*

### Tax Cost of Exits to Rise?

The current tax rate on long term capital gains is 15%. This rate applies to the sale of most family-owned businesses. The rate is scheduled to return to 20% after 2010. Most observers believe that a Democratic administration (the most likely scenario) will not renew the roll back. The rate could even rise.

Example: If a business with \$4m in EBITDA sells at 5x it yields \$20m. If all of that is a net gain the tax will be \$3m today but \$4m if it closes after 2010.

Tax is not the only factor to consider in the timing of a business sale but it should be kept in mind. One strategy is to sell part ownership of your business to a PEG now and the remainder after 2010 (in an earnout) when both the economy and the tax rate are expected to rebound.

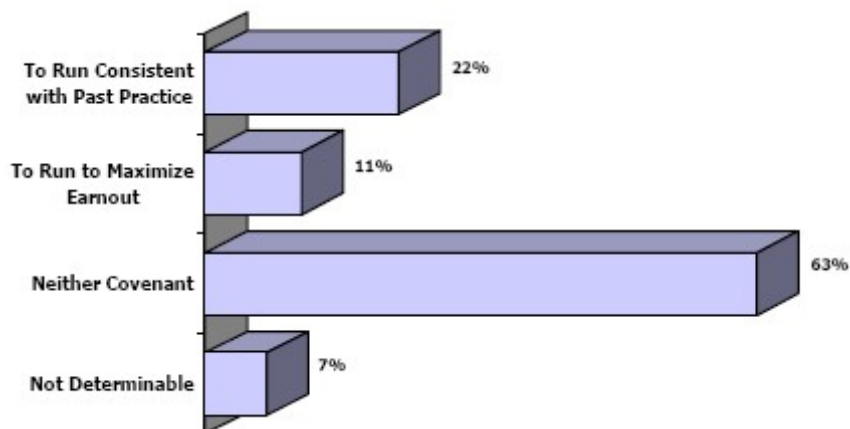
**Specializing in the Middle Market – Businesses with sales of \$5 – \$150 million.**

## Earnouts: Buyer's Covenants as to the Acquired Business

This graph is from the 2007 report by the American Bar Association's Committee on Negotiated Acquisitions. It's based on a sample of 143 such negotiated acquisition agreements available in Livedgar.com. In all cases the target was a private company and the acquirer was a public company.

The transaction range was from \$25m to \$500m. Of those transactions 19% included an earnout provision and these are broken out in the graph at the right. Note: 65% of the total of 143 were "all cash" transactions.

63% had no covenant as to how the business would be run post acquisition. This could lead



### If you're thinking like this...

1. I've negotiated for and purchased several businesses on my own over the past 10 years, now I've been approached by a private equity group that's interested in acquiring my \$20m company. Can't I sell it on my own?
2. I'm thinking about retiring from my \$60m business in 2-3 years and I'm wondering what my exit options are.
3. I need expansion capital; can't I just ask my Attorney or Accountant for some bank recommendations?
4. Is there anything wrong with running a discrete Ad in The Wall Street Journal or another newspaper advertising my business for sale? I'm frugal and hate paying professional fees.
5. How will I ever retire? I'm constantly dealing with one issue after another, from the time I wake up to the minute I leave my business at 8pm. Now I have a great new market opportunity. How do I integrate an investment in that opportunity into a longer term exit plan?
6. My business has hit a plateau, I'm making a good living but I can't seem to get beyond a certain level of sales and profits. Why would anyone want to buy my problems? I guess I'll own this until the day I die.
7. In the slow economy I'm doing better than most and I'm thinking I could acquire weaker competitors. How do I approach them without driving up their price?

### Then consider this...

- (a) Will your business performance (and therefore price) suffer if you turn your time and attention to selling the company rather than running it?
- (b) If your competitors, customers and employees know your company is on the market will this impact business sales and performance?
- (c) Which valuation model should you use for a business sale and which for raising capital and how do you defend those valuations?
- (d) If you advertise a price, that is the highest price you'll ever get even if a buyer would be willing to pay more. You'll get a better price in a discrete auction. Do you know how to run one?
- (e) How will you identify and contact hundreds of prospects to ensure you get the best price and terms at auction?
- (f) You're proud of your business but you know it's not perfect. Can you remain rational when buyers try to inflate every little blemish and offer you a derisory price? Can you turn this to your advantage?
- (g) Are you aware of the best way to structure an earnout or how to use puts and calls to your advantage in a business purchase or sale?

We all hate to pay fees if we're not going to get a return on our investment. A good tax adviser can save you many times their cost. A good investment banker will increase your net from a business sale by a very high multiple of