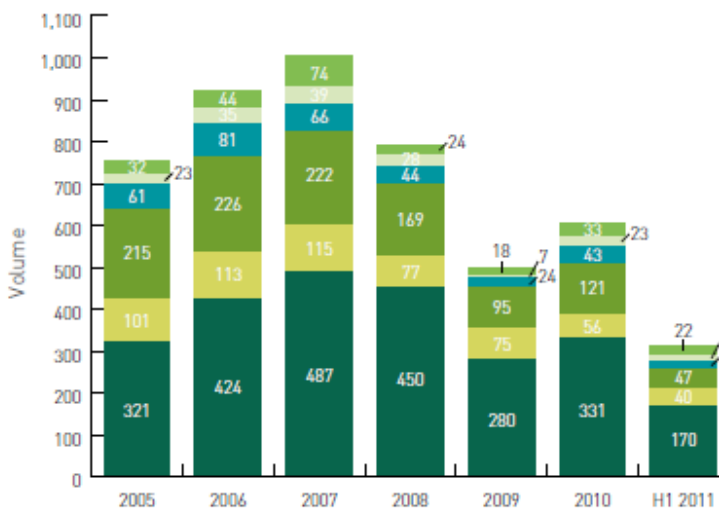


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## M&A Volume Trend by Sector: Industrials, Manufacturing & Engineering

**VOLUME**

Source: Mergermarket, "Deal Drivers North America"



Quarters 1 and 2 of 2011 were each significantly ahead of the same quarters in 2009 and 2010.

The second half of each year typically shows more M&A activity and so total volume for the year in all deal size categories is expected to continue to rise in 2011.

With US corporations sitting on nearly \$1 trillion in cash and American Private Equity groups with over \$650 billion to invest in acquisitions there is strong competition for solid businesses, even those with short term earnings slumps.

## Timing: \$10 Trillion in Baby Boomer Business Exits



According to the Exit Planning Institute, over the next 10 to 15 years an estimated \$10 trillion of wealth currently held in baby boomer owned private businesses will need to be transferred to new owners. Are the owners ready for this?

Apparently not. According to a survey by White Horse Advisors and Vistage 96% of boomer business owners agreed that having an exit strategy was important but 87% of them didn't have a written plan.

According to CMI Research, these closely held businesses account for

nearly half of private sector payroll, generate nearly 80% of net new private sector jobs and account for over 50% of non-farm private gross domestic product.

The Bush-installed Long Term Capital Gains Tax discounts are now set to expire at the end of 2012. This means that the tax on business sales will rise from 15% to something closer to 25% (probably in stages).

In this market financial and strategic buyers are sitting on a cash horde of more than \$1.6 trillion. More than a trillion of which is believed to be targeted for

acquisitions.

So why aren't there more purchases of closely held businesses? Several factors come into play:

- Traditional business valuations have not recovered to pre-recession levels so sellers believe they should wait (see also *Valuation* on page 2).
- Lack of exit planning creates fear of the unknown financial future.
- Boomers plan to be active longer and so delay exits.

Will all of this create discounted values in a big exit bubble a few years out? Perhaps. Perhaps not.

### Boomer Exit Survey

“More than half (53%) of Baby Boomer business owners intend to exit in the next 10 years.

More than half of those Baby Boomers (55%) expect to sell their business to a third party, while 20% expect to sell to employees.

Only about one in seven (14%) expects to pass the business to family.”

Per survey by White Horse Advisors and Vistage International, 2008

## Valuation: A Strong Historical EBITDA Held Back By Recession

### Traditional Valuation

All real market valuations (as opposed to Fair Market Valuations) begin with the assessment of the risk vs. the opportunity. The balance of these two factors can be seen quite differently by different classes of buyers and at different times.

### Rising Tide

When the economy, or the relevant sector of it, is booming and the economic tide is lifting all ships risk may seem small because potential buyers believe that they can earn the purchase price back in a few years. This is usually expressed as a multiple of trailing EBITDA (Earnings Before Interest, Taxation Depreciation & Amortization). For example a price that is expressed as “5x EBITDA” assumes that the purchase price will be recovered from the EBITDA in 5 years and — similar earnings will continue for many more years thereafter. Selling on trailing EBITDA was easy, if not very rational for buyers.

### Ebbing Tide

When the economy, or the relevant sector of it, begins to decline, as in a recession, every ship is suspected of being at risk of foundering. Potential buyers see a

shrinking or even negative EBITDA. As buyers still want to be able to get their money out they may base their offer on something closer to, or less than, the liquidation value of the business assets.

### Slack Tide

Once the economic tide has stabilized or begun to slowly return we have quite a different situation. While the pre-recession level of revenue and EBITDA dollars has not yet returned there are other significant factors to consider including:

1. There are usually fewer competitors due to bankruptcies and closures.
2. Due to forced efficiencies and refocus the survivors often return to modest profitability even without a recovery in revenue.
3. Given the probable closures of competitors the liquidation value of your assets has probably declined due to an over supply in the market.

### There's Good News

Once the economy has stabilized and begun to show modest new growth we are at the “new normal”.

That simply means that some level of predictability has returned.

The benefits of the “new normal” for a business seller are those expressed in points 1 and 2 above. You are now a more efficient player amongst a smaller number of competitors. As revenue returns your EBITDA as a percentage of revenue will be higher. So what new factors now go into the value estimate:

- The historical revenue that the current assets and management have demonstrated that they can produce.
- The higher current and future EBITDA Percent that a return to historical revenues produce.
- The lower cost of CAPEX due to point 3, above.

### Who Get's It and How

Many buyers are strictly formulaic and won't yet have a formula for this. With others, and to get full value, you will want to include a carefully structured earnout. This gives you share in the upside derived from what you've built while allowing buyer's to hedge their risk.

## Bon Mots

A few observations from a variety of perspectives.

“The performance gap between winners and losers [in the current economic environment] has increased over time, with the “winners” barely maintaining previous performance levels, while the losers experience rapid deterioration in performance.” - Deloitte LLP *The Shift Index*, 2010

“... [exiting small business] owners are preparing for the deal of a lifetime with possibly zero experience..”

- Per MorganStanley SmithBarney publication, 2011

“...the U.S. economy remains almost comatose. In a normal rebound, Americans would be witnessing a flurry of hiring, new investment and lending, and buoyant growth.

...The current slump already

ranks as the longest period of sustained weakness since the Great Depression. ...once-in-a-lifetime dislocations will take years to work out. Among them: the job drought, the debt hangover, the defense-industry contraction, the banking collapse, the real estate depression, the health-care cost explosion and the runaway federal deficit.” *Time Magazine* economic forum 9/28, 1992



## There are no “10 easy steps” to a business exit.

We’ve all seen articles and books that offer “10 easy steps” or “the ten insider secrets” to achieve success and riches. Just as bogus as these are the 10 easy steps to selling a closely held business (i.e. with few shareholders). Selling a business is hard work that needs to be well-executed and “10 easy steps” just won’t cut it. Good execution requires skill and experience but even before you take the first steps to hire the right advisors you need to determine if you are prepared to start. This begins by asking yourself a lot of questions even before you engage an investment banker to begin the process. Here are a few “true or false” questions to get you started.

1. Running my business is less enjoyable than it used to be.
2. My business is important to me but does not define who I am.
3. Without me around the business could run very well under other managers.
4. My business has no unusual tax, environmental or legal encumbrances.
5. I am the sole owner or I have a shareholders’ agreement that enables me to deliver ownership of the company or its operating assets to a buyer.
6. I have a plan for what I will do after the sale of my business.
7. I have worked with a financial advisor to determine what I will need in a well-managed program to support my post sale plans and requirements.
8. My business has a history of positive EBITDA (Earnings Before Interest, Tax, Depreciation and Amortization) when adjusted for my lifestyle expenses.
9. I understand that I will get less for my business if I want all cash at closing.
10. I understand that the cost of using experienced advisors (M&A attorney, investment bank, , financial planner, etc.) will be well exceeded by what their input will contribute to the net proceeds.
11. I understand that a sale can take 6 months to 18 months or more.
12. I am committed to put in the time it takes to prepare for and execute a sale.

Obviously not all of these questions are of equal importance but if you answered “True” to at least 9 of them you’re ready to start interviewing potential advisors to find out more about the sale process.

## Invitations to Treat

A potential buyer who is seriously interested in acquiring a business will usually submit some form of “invitation to treat” which is a written notice that they are ready and willing to negotiate. These invitations usually come under one of the three common headings described below. What they have in common is that even if accepted all of the substantive details remain to be negotiated and finally accepted in a definitive agreement. Nonetheless they are valuable to both buyers and sellers as a starting point.

### Letter of Interest

This is the most limited document because it contains no commitments or binding clauses. It is merely a demonstration of interest and a bare outline of the kinds of terms under consideration. If signed by both parties it merely indicates that the parties are willing to continue the discussion around the terms outlined. Its primary purpose is to get a mental commitment.

### Letter of Intent

A letter of intent, (which confusingly, shares the acronym “LOI” with Letters of Interest) also contains an outline of the terms sought by the buyer, most of which are non-binding. However, it usually contains several important binding terms including:

1. Exclusivity: Often called a “no shop” clause it gives the buyer an exclusive period of negotiation with the seller during which the seller cannot talk with other potential buyers. It is not reciprocal. This should be no longer than 30-45 days.
2. Confidentiality: The parties will probably already have signed a confidentiality agreement and this is often referenced in the Letter of Intent as surviving the expiry of the LOI.
3. Good Faith: In some states the buyer may recover “reliance damages” if the seller does not negotiate in good faith.

The LOI should lay out several key points in some detail

including the following:

1. Consideration (i.e. price).
2. What is being purchased: Is it the corporate entity or the company’s assets?
3. Structure: In what form and in what stages and on what dates will the price be paid?
4. Role of Sellers: Will the sellers continue with the business in some capacity?
5. Due Diligence: What period will the buyer be given to verify the details of the business and obtain any required approvals (regulatory, landlord, etc.) prior to closing? This period should be coterminous with exclusivity.

### Term Sheet

This form is more often used in Angel and Venture Capital transactions than in outright business sales. It gets very detailed about share classes, conversion rates, preferences, drag-alongs, voting rights and so on. Its only binding terms are exclusivity, good faith and confidentiality.



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Blackbridge Partners LLC is a Boston-headquartered investment bank. We specialize in merger and acquisition and capital raising advisory services for owners of privately-held lower middle market companies seeking to harvest maximum value upon exit and companies seeking to acquire the same.

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Our experience ranges from medical services to manufacturing, software, IT services, technology and professional services.

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

## What's the Business Sale Process Like?

Harvesting the maximum value from your business takes time and requires a considered process.

### Financial Records

You should clean up and standardize your financial records including the Profit and Loss statement, the Balance Sheet and keep these updated monthly. By "standardize" we mean that you should organize and present the records as if you were the division of a larger corporation. In particular you should ensure that:

1. All salaries and benefits for the owners and their family are at "Fair Market Values".
2. Non-working "employees" are taken off the payroll.
3. Personal lifestyle expenses (cars, vacations, entertaining) are clearly identified in the accounts and added back.
4. All discretionary expenses (charities, non-contractual bonuses, etc.) are clearly identified in the accounts and added back.
5. Etc.

### Legal Matters

Ensure that your corporate minute book and annual filings are up to date and that the incorporation documents, the minutes and shareholders' agreement empower you to sell the business. Best to have this reviewed by an attorney.

### Valuation & Evaluation

What is the business worth and how do you find that out? Many business owners consult with accountants or talk to a valuation firm. They will give you a Fair Market Value but this doesn't always correlate with the

Real Market Value in an actual sale. The best step is to consult with an experienced investment bank. To see what is a reasonable value in the hands of different types of buyer and what factors are likely to impact that value. They should do this evaluation at no charge because its part of their own evaluation process.

### Digging Deeper

When you interview investment bankers prior to selecting one to work with there will be a lot of Q&A. They will not only want to consider the question of value and structure but should also ask about client concentration, supplier dependence, industry cycles, CapEx requirements, technology dependence, age of equipment, inventory levels, AR/AP patterns, second tier management, competition and so on. All of this is done confidentially and with no obligation between the parties as part of the process to gather the necessary background to give a meaningful opinion of real market value in the hands of different classes of buyers.

### Fees

There will be expenses related to selling your business. These will include modest legal and accounting fees prior to going to market as well as more substantial legal fees to memorialize the deal in a Purchase and Sale Agreement. There will also be taxes and fees to your investment bank. Blackbridge aligns its interests with those of its clients by not charging open-ended monthly retainers, which can encourage delay.

Blackbridge charges a modest fixed fee at engagement, and recovers certain expenses as incurred, but charges no other fees until the sale is successfully completed and the seller is paid. This is a performance based fee. If a sale never happens the fixed engagement fee is the only fee that Blackbridge will receive.

### Length of Time

If the sellers records are in order it can typically take 60-90 days to get to market. This includes developing a target list, preparing the blind profile and the Confidential Memorandum and their approval by the client. Thereafter a sale could take as little as 90 more days or as long as 18 months or more, depending on the buyers pace.

## Survival of Obligations

Included in a Purchase and Sale Agreement are the "representations and warranties" of the seller. These are statements of fact by the seller that the buyer is expected to rely on. If they later prove to be false the buyer may sue to recover damages. To avoid uncertainty they are usually accompanied by a "survival clause" which limits their life to a certain time period (e.g. 90 days).

If the survival clause is not explicit enough it may only serve to limit the notice period within which the buyer must raise a concern and may not prohibit the commencement of litigation long after the contract date (up to 6 years later, depending on the state). Confer with your attorney about the drafting of all agreements.