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Mind Your Own Business
In This Issue: Controlling the Exit

Blackbridge PARTNERS LLC

Inside:

"... a business seller will net over $2.5 million more... when represented by an investment bank"

What's the Difference?

Loans that have adjustable interest rates are usually tied to one of two benchmark rates as published in a named financial newspaper on a particular day.

LIBOR – **L**ondon **I**nter-**B**ank **O**ffer **R**ate. This is the interest rate that banks offer to one another for loans ranging from overnight to 5 years. This rate is usually fixed once a day but can change within a day.

Treasury Bills – This is the rate of interest on U.S. Treasury Bills (or T-Bills). These are loans to the government having a maturity of one year or less. T-Bill rates tend to be more stable in times of economic turbulence.

The difference between these rates is the "TED spread".

Bargain Hunters and Bottom Feeders

The current economic environment is ripe for the bargain hunters and bottom feeders who trawl for undervalued acquisitions. How do you recognize them and deal with them?

This class of buyer can initially look just like any other interested party but they usually begin by making a direct and unsolicited approach to a target business rather than responding to an offer for sale (this is not to say that all such approaches are by this type of buyer). They get attention by floating a possible price that falls within a reasonable range.

Thereafter the bottom feeder will quickly try to lock in a no-shop period (an exclusive negotiation period) that is relatively short (30-60 days). Having gotten some level of commitment from the seller the bottom feeder will begin to slow down the pace of the process.

They believe that the longer they draw out the process the more opportunity they will have to drag the seller down on price and terms. Amongst their tactics:
- repeatedly bringing up minor issues to justify lower offers,
- submitting written offers that are inconsistent with verbally agreed terms,
- inserting undefined "material adverse change" contingencies allowing them to *justify* a price reduction later on.

If a bottom feeder is interested in your business then it's likely that full value buyers will also be interested. The best way to screen out bottom feeders and to get full value is to have several offers to consider at once.

To attract multiple competing offers (while protecting your business) you'll need to conduct a confidential auction. In the context of that auction the bottom feeders will be easy to weed out.

Getting the Best Price in a Business Sale: A third party's view

5x EBITDA = proprietary deal flow
8x EBITDA = investment banker's auction
EBITDA = Earnings Before Interest, Tax, Depreciation or Amortization
Data Source: *Mergers & Acquisitions*, November 2008, page 33

If you're approached by a legitimate buyer (another business, a Private Equity Group, etc.) and are inclined to sell your business it seems easy and sensible to go it alone. That is, to sell your business on your own without paying any fees to an advisor (such as an investment bank). There's no doubt that, with good legal advice, you can close a deal but is it in your best interest to do so?

This scenario is what buyer's call "proprietary deal flow". That is, the buyer "owns the deal" and doesn't have to compete with other buyers on price or terms. Not surprisingly experienced buyers like proprietary deal flow because it creates an asymmetry that is strongly in the buyer's favor. First, they've done deals many times before. Second, while they may not be bidding for your business against other buyers you will probably be competing against other sellers that you're not aware of and that they're simultaneously negotiating with.

The financial effect of this asymmetry is demonstrated in the chart above. This data was extracted from an advertisement placed by a firm that specializes in sourcing "proprietary deal flow" for buyers. Their chart shows that a seller with $1m EBITDA working with an investment banker will get a price that is $3 million higher then a seller working alone.

In their view a business seller will net over $2.5 million more (pre-tax, after fees) when represented by an investment bank. While the multiples will vary by sector and deal size the benefit is clear even before considering the added value from other terms.

"My business is the largest asset in my portfolio and I need to diversify my risk."

Survival of Family Businesses

A recent University of Southern Maine study showed that only 30% of family businesses successfully transition to the second generation.

A separate study published in June 2008 (conducted for a division of Bank of America) found that only 15% of family businesses survive beyond that second generation.

As the Wall Street Journal opined on the latter study: *"In other words, if you have a family business, you should put business before family. A happy business will mean an unhappy family, and a happy family can produce a bad business."*

"Prepare your business now to take advantage of the right exit opportunity… or to deal with any exit necessity... that might arise unexpectedly."

The Timing Dilemma

In the current environment many business owners are faced with a dilemma:

- On the one hand it may be time to seek new capital for growth or to begin to take some capital out of the business .
- On the other hand sales, profits and confidence are down while costs and interest rates are up.

While the press focuses on the worst news from Wall Street there are still good options available if you're seeking cash or liquidity, but is the timing right for you?

Maybe I should delay:

1. Sales and profits are down or slowing down and this may not allow me to get the best value if I recapitalize now and/or convert some of my equity into cash.
2. I'm an entrepreneur and I need to continue to be actively involved in strategic management.
3. I don't want to take on long term debt in this economic environment.
4. I'm not yet ready to give up control of the business that I've built up.
5. I won't be ready to exit or retire for at least 3 years.

Maybe I should act now:

1. This environment has created opportunities for organic growth and/or growth through acquisitions if I could only free up some capital.
2. My business is the largest asset in my portfolio and I need to diversify my risk.
3. The capital gains tax is scheduled to reset from 15% to 20% after 2010.
4. I'm not yet ready to give up control of the business that I've built up.
5. I'm not ready to exit or retire for at least 3-6 years and need a plan that will ensure an exit at the best value then.

Make the Timing Work for You

Here are some additional timing factors you should consider.

It takes time to get it done so plan ahead:

- Once you're aware of your available liquidity options it can take 3-4 months of discussion and research to decide on the best course of action.
- It may take 3-4 months or more to get to market once you make the decision to do so.
- It typically takes from 8 to 14 months after going to market to close on the right deal for you.
- If you don't get the right deal it's always your option to decline or postpone a sale, without any penalty.
- If you wish to fully liquidate your equity in a single transaction you will likely still have an earnout agreement (milestone-based payments) for 1–2 years (see page 4).
- If you decide to liquidate only part of your equity (a minority or a majority interest) you'll get a "second bite at the apple" (the sale of your remaining interest). This second bite will probably happen in a better economic environment and at a higher value.

Consider the window:

- The credit crunch has made strategic and financial buyers much more interested in smaller acquisitions (<$50m) because these don't need to be financed with debt. This interest may not survive the recovery of the debt markets.
- The current interest in this lower middle market has created a competition for good businesses that gives owners a chance to get a higher price and better terms in an auction (see chart on page 1).
- A partial exit now, with an option to sell the rest later, allows owners to complete their exit in a revitalized economy and manage the timing of that event.

No one can predict the future but it is generally believed that this particular window of interest in the lower middle market will start closing within 2 years.

Consider your plans and your options and decide if you should investigate further now.

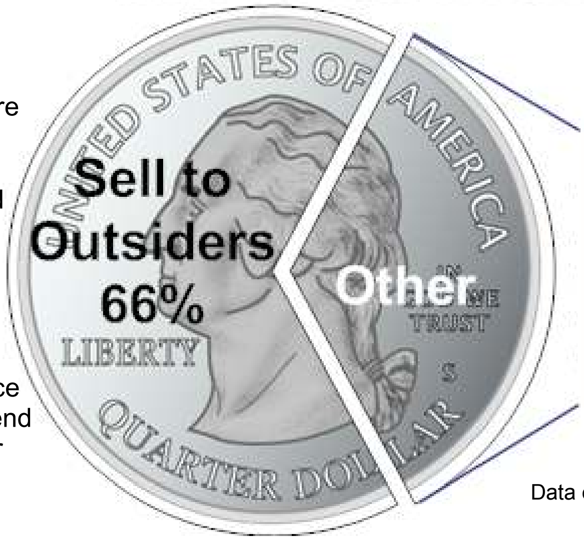
Conclusion: Plan at least 3 years ahead. Prepare your business now to take advantage of the right exit opportunity (the right offer) or to deal with any exit necessity (incapacity, divorce, death, etc.) that might arise unexpectedly.

Business Exit Factoids

- " Women and men business owners are equally concerned about price when selling their business.
- Women owners who plan to sell are more concerned than their men counterparts about:
  - ⇒ the buyer's identity, personality, and background (72% vs. 39%)
  - ⇒ the buyer's plans for the business (79% vs. 52%)
  - ⇒ plans for current employees (86% vs. 61%)
- Women business owners are nearly twice as likely as men business owners to intend to pass the business on to a daughter or daughters (37% vs. 19%)."

Source: Center for Women's Business Research

Small Business Owner Exit Plans



Other:

- **Go Public = 28%**
- **To Partners = 23%**
- **To Children = 17%**
- **To ESOP* = 16%**
- **Other = 18%**

* **E**mployee **S**tock **O**wnership **P**lan

Data extracted from September 2008 *Inc. Magazine* survey.

The Real Deal: Examples of active inquiries

Blackbridge is known as a middle market business sellers' investment bank. Consequently, strategic and financial buyers regularly update us on their acquisition interests to see if we represent any businesses of interest to them. Each of the following example inquiries is aggregated from multiple actual current inquiries.

1. Niche Manufacturing

- Sectors include test, measurement, sensors, temperature control, flow control, bio-filtration, etc.
- Current revenues in the range of $5m to $100m.
- Historical profit margins of 10%-15% (recent softness possible).
- Existing owners may retain a residual interest (minority or majority depending on seller's liquidity requirements) with their additional future liquidity to benefit from the upside potential.
- Should have a dedicated management team in place to execute near term growth strategy (organic & acquisitions) with the investor's financial support.
- Appropriate incentives provided for owners and managers to achieve growth plans.
- Generational transition of family business, recapitilization for growth, owner liquidity or retirement.

2. Business Services and Logistics

- Including HR, advertising, business process outsourcing, materials handling, security, etc.
- Revenues of $5m-$50m.
- EBITDA $1m+.
- Historically strong margins.
- Minimum 3 years of profitable operations.
- Low to medium technology risk.
- Diverse and growing customer base.
- Fragmented and growing markets.
- Owners willing to participate in the growth strategy for a period after sale.
- Can provide sellers with flexible liquidity and long term financial options.

3. Distribution Services

- Differentiated by value added branding, merchandising or unique processing.
- Revenue $5m-$75m.
- Gross margins of at least 20%.
- EBITDA of $1m or more.
- Wish to partner with existing management to unlock the business's potential.
- Prefer to acquire a majority position.
- Will finance further growth with ordinary or preferred equity or convertible debt.

4. Materials & Processes.

- Including chemicals, powders, coatings, plating, metals, sealants, lubricants, etc.
- Funding for management buyouts, new growth capital, recapitalizations, shareholder liquidity and complete exits.
- Revenue $3m-$30m.
- EBITDA >15%.
- Management in place.
- Sustainable competitive advantage supported by patents.

"We wish to partner with existing management to unlock the business's potential."

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

As a leader in mid-market sales, mergers and acquisitions, investment banking services, and corporate recapitalizations we deliver professional client services to a global audience with first class results.

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

Incentive Payments

Some common types of post closing incentive payments:

- **Bonus Payments**: A sum paid to sellers who stay on as managers which is triggered by defined performance targets, such as sales growth of X%.
- **Escrowed Funds**: A portion of the price reserved in an escrow account that is triggered for release when defined goals are achieved, such as regulatory approval (not to be confused with escrowed funds held as insurance for Reps and Warranties).
- **Holdback Allowances**: A portion held back by the buyer (rather than placed in an escrow account) to be paid upon satisfaction of a post-closing trigger condition, such as regulatory approval.
- **Stock Options**: The rights to acquire shares at a fixed price within a defined time window that usually commences at some time after a triggering goal is reached, such as sales goals.
- **Earnouts:** Payments contingent upon post acquisition performance progress that are usually measured by formulas that take into account one or more factors such as sales, gross margins, net profit, cash flow, etc.

All of these incentives, but for earnouts, typically have a clear and single trigger for the incentive payout to be made. Earnouts are more complicated but can also be more lucrative.

Earnout Metrics*

Here are some earnout metrics from a recent large scale study of private companies that were acquired by public companies (sample size=990).

1. **What percent of the price?** When there was an earnout it averaged 33% of the total expected price. In 75% of theses cases it fell in the range of 16%-47%.
2. **Based on who's performance?** In 90% of cases the earnout was based solely on the financial performance of the acquired business. In 9% of cases on the performance of the combined businesses. In 1% on other criteria.
3. **Step or Linear?** About half of the earnouts were based on a series of steps (the next step up in payment linked to the next step up in performance). The remainder were based on linear calculations setting no floor for an increase.
4. **Over what time period?** The average earnout period was 2 years with the bulk falling within the range of 1 to 3 years, but some were more than a decade.
5. **Measured when?** In 77% of cases the performance measures were taken annually. In 5% they were semi-annual and in 4% quarterly. In 12% of cases the interval was more than a year.
6. **Measuring what?** In 24% of cases the measure was sales, in 48% of cases "cash flow", and in 32% "net income". 37% used non-financial criteria. Obviously, almost half used multiple criteria.

Earnout Cautions

Even for experienced professionals a good earnout agreement is complicated to negotiate, structure and memorialize. Please don't try this at home. Here are a few cautions.

1. **Integration:** If the target is to be fully-integrated into the buyer then predefine how the target's performance will be isolated.
2. **Control:** You're paid on performance so you'll need to have significant control over, and/or influence on, the business's performance during the earnout period.
3. **Early Out:** Pre-define events that trigger an early exit (e.g. loss of control) and the formula for calculating an accelerated earnout.
4. **Metrics:** Use a linear measure of performance that's as close to the top of the Profit & Loss statement as possible, ideally sales.
5. **Mind the GAAP:** **G**enerally **A**ccepted **A**ccounting **P**rinciples are too flexible to rely on. Tightly define all financial calculations.
6. **Set Realistic Goals:** You have to earn it so be sure that you can.
7. **Happy at Closing:** Get enough cash at closing that you can regard the earnout as a nice earned bonus.
8. **Rely On Experienced Advisers:** An earnout is a "deal" first and then a contract. Get experienced assistance on negotiating the right deal terms and structure before transferring it to an experienced M&A attorney to be memorialized.

*Cain, Matthew D. & Denis, David J. & Denis, Diane K., 2006. "Earnouts: A Study of Financial Contracting in Acquisition Agreements," Purdue University Economics Working Papers 1196, Purdue University, Department of Economics.