PRIVATELY HELD COMPANY

the report on transaction issues

CK BUSINESS CONSULTANTS, INC.

is your Merger and Acquisition Specialist! We represent clients in their search to sell or acquire companies, divisions, or product lines. We handle all phases of the project including valuations, marketing strategies, and execution of the transaction in a confidential and professional manner.

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Closing the Buyer-Seller Price Gap

The price gap in the middle-market-sized business is real and not just posturing between buyer and seller. The overriding factor to bridge the gap is whether the principals are truly willing to do a deal and whether their respective advisers are clearly helpful.

Following are some suggestions on how to close that gap.

Ideas on How to Structure the Deal

(Please Note: A securities license may be required for a few of the ideas mentioned below.)

- Acquire 70% of seller's stock with a call on the remaining 30% (10% each year for three years).
- Leave the real estate with the seller in order to reduce the price and then rent the facilities. Additionally, the seller can keep the major machinery and equipment and lease it to the buyer as well, thus reducing the transaction price.
- Structure royalty on sales rather than an earnout on gross margins or EBIT.
- Pay a higher rental as part of the package price, thus reducing the goodwill factor.
- Create a subsidiary for the fastest part of the business in which buyer/seller share 50/50 in that piece of the business that "takes off."
- The second generation sellers could take back preferred stock equivalent to 10% of the transaction amount.

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Additional Tactics

- Sellers should be willing to hire additional and/or different advisers who are "real pros" on issues of valuation, structuring, tax, etc. The business transaction process is a delicate matter that needs careful communication.
- If a strategic buyer is principally interested in a product line within the selling company, make an offer on only the product line, leaving the balance to be sold off to another party.
- As a buyer, engage a third party (a straw) to buy the stock of the selling company (usually a lower price), then the buyer makes an asset purchase from the third party slightly above the stock price. *Precaution: Consult your attorney and tax adviser for legal and tax advice before proceeding with this additional tactic.*
- Find aspects of the deal, other than price, which are important; e.g., ongoing owner involvement, retaining the name of the company, employee retention, etc.

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- As a buyer, meet the high asking price or bid high in an auction, then try to renegotiate the price during due diligence.
- Break down the prospective transaction into component parts (the seller, the buyer and the transaction itself) for further analysis and options. What leeway do the two parties have with stock or asset deal, earnouts, financial concerns, etc.? Regarding the transaction itself, use comparable transactions and fair market values for benchmarks.
- Get professionals involved with estate planning for the seller in order to structure more after-tax benefits.

Tactics for Overseas Transactions

- In an overseas transaction (a U.S. acquirer buying an Italian company, for example), the consulting agreement is paid by the U.S. parent to the individual Italian seller instead of having the new Italian subsidiary paying the fees. The seller might treat this as tax-free payments because it is not reported in Italy.
- In Europe, where pride of ownership is sometimes paramount, sell 49% to buyer, sell 11% to a trust controlled by the buyer, and leave 40% of the equity with the seller. It then appears to the community/employees that the seller still has a significant interest in the company.
- If the European seller establishes a holding company in Switzerland for the intangibles (e.g., trademarks and patents), then a separate payment can be made for these assets, thus avoiding the capital gains tax on that portion of the business.

Doing Quick and Timely Diligence

The time from Letter of Intent to Purchase and Sale agreement seems to be getting shorter and shorter. The current timing for due diligence from the signing of the Letter of Intent can be as brief as 30 days, but is very rarely more than 60 days. This makes the diligence process even more important, yet more difficult to accomplish.

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Which areas are most time-consuming or costly? What are ways to do quick, yet complete diligence and still keep the costs under control?

- **Use outsiders.** Make use of marketing consultants, environmental experts, valuation professionals, etc., more and earlier to perform due diligence.
- **Form a team.** Successful buyers have experienced teams that have done deals before and work well together. These teams are made up of both management and outsiders.
- **Plan ahead.** Organize diligence efforts well in advance.
- **Prepare the other side.** When dealing with private company sellers, it is necessary to pre-sell the diligence process, particularly the mountains of paperwork. The patience level of the seller must be gauged.
- **Begin early.** The earlier the due diligence starts on all fronts, often before the Letter of Intent, the fewer unpleasant surprises there are for both sides.
- **Place more focus on indemnification.** Reps and warranties generally are not a solution to a difference. Both parties need to resolve issues in other ways. It is helpful to place more focus on indemnification versus reps and warranties.
- **Select the right advisers for offshore deals.** When doing offshore deals, use advisers from the country of the buyer to assure advisers are loyal to the buyer.
- **Look ahead for surprises.** Look for potential surprises in the selling company such as the niche business not being as strong as purported, or the selling company not really being that well positioned for growth.
- **Don't forget management.** Buyers will want to conduct background investigations on the management of the selling company as an additional due diligence safeguard.

Dealing With Growing Deal Prices

In a growing economy, what can buyers do to make more of these transactions economically viable? Buy smaller businesses? Add unique value? Consider joint ventures or minority interests? Implement creative financing, accounting and/or structuring?

- Buyers should be prepared to sit on the sidelines, be patient and wait for the right pricing or the right deals.
- Higher price creates greater risk for the financial buyer than for the strategic buyer. Buyers should stay with businesses that they thoroughly understand to mitigate the risk of the unknown.
- Have well-defined exit strategies or refinancing strategies.
- Look at out-of-favor industries and companies where multiples are lower.
- Increase proprietary deal flow and overall deal flow.
- Strategy and synergy should drive the deal. In other words, financial re-engineering, so popular in the '80s with leverage buyouts, is dependent on selling off extraneous units, slashing overhead and working capital. In today's marketplace, fewer companies are left that have not already been restructured.
- Assuming the buyer is a public company, use high P/E stock to help finance the transaction. Also, deals done with stock avoids the long-term write-off of goodwill; goodwill write-offs reduce reported earnings.
- It is necessary to do more due diligence when the acquisition multiples are higher because the higher price creates higher risk of financial success. Therefore, buyers need the best due diligence representation, and the buyers should take more time to analyze what's presented to them.

Is This Your Company?

Have you charged yourself with the responsibility of evaluating the status of your company to be sure there are no “skeletons in the closet” and that you won’t be trying to sell a “pig in a poke”?

If you have not already done so, it may be helpful to outline the three most important areas of concern -- finance, management and marketing -- and then review each of those areas using the questions listed below.

Finance

- *Cash*
  Is your company taking trade discounts or able to buy at the quantity price? Do you pay trade payments on time? Does your firm have good cash management?
- *Bank Problems*
  Is your company out of financial ratio? Is it under particular scrutiny from the bank? Has it used its complete credit line and/or have suspect relations with its bank?
- *Outdated Financials*
  Does the company have monthly financial statements and detailed financial cash flow projections? Are the company’s annual financial statements completed three to four months beyond year end, and are the statements unaudited?

Management

- *Continual Crisis*
  Are you constantly interrupted by emergency telephone calls and secretarial demands for immediate decisions?
- *Substantial Changes in Key Personnel*
  Would a review of the last three years of management show an unusual turnover in key positions, including CFO, sales manager and vice president of manufacturing?
- *Substantial Lack of Change*
  Have there been little or few changes in senior management over the years? It may indicate a stagnant business not up with the times and dominated by the CEO.
- *Company Pride*
  Does the company as a whole demonstrate a lack of pride in the company? While pride is somewhat subjective, one can often sense the tempo and spirit of the personnel by the tone of their voice and bounce in their stride.

Marketing

- *Loss of Market Share*
  The key in evaluating market share is to be able to compare unit volume increase or decrease with the direct competition. Sometimes specific price increases will increase dollar sales, but the true measure is unit sales.
- *Trade Shows*
  Does your company show interest and activity at the trade shows in the company’s booth compared to the competition?
- *New Products*
  The rate and success of new products, services, etc., is partially related to the extent of the company’s ability to look ahead. Part of 3M’s success is due to it’s goal to generate 30% of revenue from new products introduced in the past five years. How does your company compare?

It is up to the owner and/or CEO to make sure their company doesn’t peak or “turn south.”

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INDUSTRY BBP EXPERT

This latest issue of the Private Market Report is compliments of Gary Papay, CBI, M&AMI. Gary is president of CK Business Consultants, Inc. and is an active member of the M&A Source. Gary has been involved in the sale and acquisition of businesses since 1976, and is available to handle all of your merger, acquisition or divestiture needs.