PRIVATELY HELD COMPANY

the report on transaction issues

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Why Deals Fail to Close

When deals fail to close, everybody involved with the transaction is disappointed – or worse. The issues causing a halt in the closing process may be insurmountable or they may be minor. If minor, they may be able to be resolved when handled appropriately.

There are dozens, if not hundreds of reasons why deals do not close. It all starts with the Letter of Intent which transforms the verbal agreements into a written document. However, the devil is in the details. The reps and warranties, the indemnities, employment contracts, noncompete agreements – all are potential deal breakers. In addition, every transaction has a unique mix of personalities and potential personality conflicts between the attorneys, accountants, the boards of directors (if any), the sellers, and the acquirers.

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Business intermediaries can be a big help in keeping the deal moving forward and in smoothing out any disagreements.

Continued on Inside

Why Deals Fail to Close (continued from front page)

Business Brokers have experience in dealing with the following.

Acquirers:

- who lose patience and give up the acquisition search prematurely, maybe under a year's time period.
- who are not highly focused on their target companies and who have not thought through the real reasons for doing a deal.
- who are not willing to "pay-up" for a near perfect fit, failing to realize that such circumstances justify a premium price.
- who are not well financed or capable of accessing the necessary equity and debt to do the deal .
- who are inexperienced as buyers yet unwilling to lean heavily on their experienced advisors for proper advice.

Sellers:

- who have unrealistic expectations for the purchase price.
- who have second thoughts about selling, commonly known as seller's remorse and most frequently found in family businesses.
- who insist on all cash at closing and/or are inflexible with other terms of the deal including stringent reps and warranties.
- who fail to give the intermediaries their undivided attention and cooperation.
- who allow their company's performance in sales and earnings to deteriorate during the selling process.

Earnout Strategies

"The objective is to quantify uncertainty."

It is no revelation that acquirers want to acquire companies based on "today's" earnings and "today's" book value. On the other hand, sellers want to sell their company based on "tomorrow's" expected earnings.

Many potential acquirers are accustomed to offering sellers, for example, five times EBIT or up to two and one half times book value by structuring the deal with 30% equity, 50% borrowed from the lender and 20% notes or consulting/non-compete agreements with the seller. Unfortunately, this former conventional structure does not often prevail for the acquirers.

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Many successful acquirers go beyond the conventional norm in bidding for a company. For those acquirers which are public companies, the use of their publicly traded stock is an obvious advantage. For those acquirers which are private companies, the remaining trump card to use to "pay up" for a desirable acquisition is the EARN-OUT.

According to James W. Bradley, co-author of *Acquisition and Corporate Development:*

> The earn-out is a contingent purchase which allows some deals to go through that would otherwise be impossible. Sometimes the seller's price is such that the transaction can only be justified by the buyer at levels of future earnings considerably above what the buyer can expect with any degree of certainty. Here an earn-out may allow the deal to be consummated. Under certain circumstances earn-outs may qualify as non-taxable transactions.

Earn-outs can be complicated to structure and monitor, but they are most desirable under the various scenarios:

- The buyer has limited equity.
- The seller has very rich price expectations.
- There is a significant price gap between buyer and seller.
- Acquisition of service companies (relationship businesses).
- Acquisition of companies introducing new products.
- The owner is willing to stay on two to five years.

Earnout Strategies (continued from previous page)

An example for an earn-out formula used by a very successful New York Stock Exchange Company is as follows:

a) Pay the owners one to two times book value at closing.

b) Then pay owners an additional percentage of Net After Tax (N.A.T.) over a five year period.

c) The payment based on the multiple of book value (a) is finally deducted out from the earn-out payment (b)

d) Sample of earn-out:

Year		Net After Tax Multiple
1	x	15%
2	x	15%
3	x	20%
4	x	25%
5	x	25%

Considerations

The acquiring company usually places a maximum earn-out or "cap" on the deal. The acquirer will want to be sure that the income from the earn-out comes from continuing operations and not extraordinary or non-recurring events. One of the reasons the earn-out works for both parties is that the acquirer agrees to invest money in the acquiree – computer systems, marketing plans etc. – to help accelerate the N.A.T. While a definitive dollar amount is not pre-determined, the acquirer wants to make every effort to please the owners, because the success of the next acquisition will be voiced by the owners of the last acquisition.

The above variation is just one example of numerous alternatives. In fact, the most common benchmark for earn-outs is a percentage of Earnings Before Interest and Taxes (EBIT) with covenants regarding which party makes major decisions, what changes will be allowed, and if necessary, how to implement arbitration.

If a seller is willing to accept an earn-out arrangement, a more aggressive pricing strategy can usually be formulated. The objective of the earn-out is to quantify uncertainty. Earn-outs are used to bridge gaps between an asking price and a bid price as well as to motivate the seller during the period of transition. And, one should recognize that the seller must be satisfied with the initial "down payment" as compensation for the company. Any earn-out payments, if and when they come, are "gravy."

Conclusion

There are some manufacturers who are very vulnerable, because they have but a few customers or some distributors who have but a few suppliers. These are often necessary situations in which acquirers must protect themselves with an earn-out arrangement. Furthermore, there has been a tendency to use earn-outs as a method of protecting the purchaser who has not done an adequate due diligence investigation.

Earn-outs should be limited to offering solutions to legitimate differences or when a seller's major concern is to spread out income in taxable transactions with resulting tax benefits. The success of earn-outs is only limited by the principals' creativity and willingness to compromise.

The Process of Selling Troubled Companies

Before the process of selling troubled companies is addressed, it is important to first determine whether, in fact, a company is considered "troubled."

Obviously, there are different degrees of how one might classify troubled companies, but some of the following characteristics would indicate that the company is in trouble:

- Negative book value
- Rapidly declining earnings or negative earnings
- Default of the bank loan covenants
- Inability to meet debt obligations
- Rapidly running out of cash

The objective in selling a troubled company is to get out of the situation with the least amount of debt obligations and as quickly as possible, before the company further deteriorates.

By determining that the company is in a state of trouble, the owner can substantially accelerate the process of selling the company. This is important, because time is of the essence. To assist in selling a company more quickly, the owner of a troubled company should be far less concerned about confidentiality and be willing to contact direct competitors that otherwise might be avoided.

Owners of healthy companies are trying to maximize the selling price through a very controlled and confidentially orchestrated selling process. The objective in selling a troubled company is to get out of the situation with the least amount of debt obligations and as quickly as possible, before the company further deteriorates.

The process of selling a troubled company should include four basic steps.

1. Figure out why the company is in trouble.
2. Determine what you would be selling and what you can realistically expect to get for the business.
3. Decide the when, who and how of marketing. When should the company be marketed? Who should the company be marketed to? And how should the company be marketed?
4. Develop a negotiation and transaction structure strategy.

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