WINTER 2013
DuaneMorris®
INNOVATIONS @ HAND
PRIVATE EQUITY
The Owner's Manual
An introduction to proper maintenance of your company and your estate.
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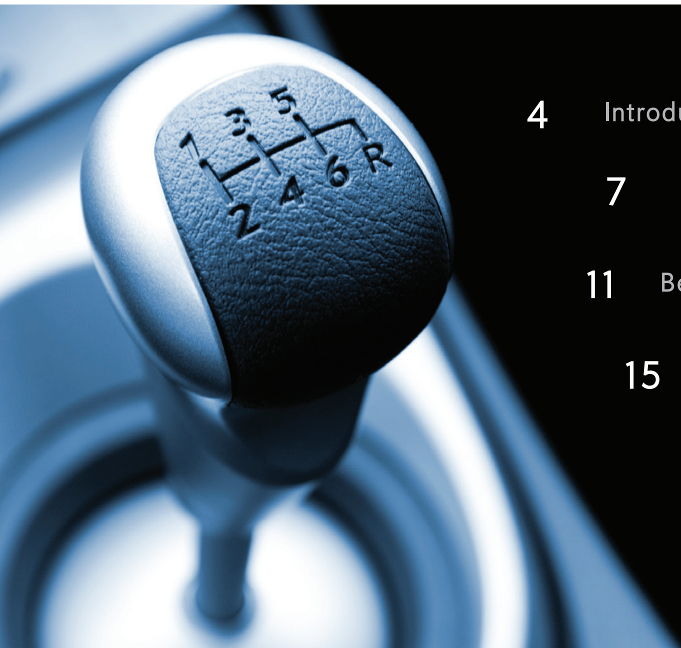

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DUANE MORRIS LLP – PRIVATE EQUITY GROUP

With experienced private equity lawyers across our domestic and global platform, coupled with the deep capabilities of more than 700 lawyers, Duane Morris offers the resources to optimize transactional value; provide guidance on fund formation and exit strategies; and support and expand portfolio company operations. With our strategic focus on the middle market, broad experience in major industry sectors and an innovative culture deeply committed to client service, Duane Morris is regularly called upon to work with the most sophisticated and demanding players in the middle market.

To Our Readers:

Business owners face a myriad of issues when building their businesses. These issues range from developing a product or service, to attracting customers, selecting suppliers, arranging financings, retaining employees and fending off competition, to name just a few. A business owner is bombarded on a daily basis with challenges like these, requiring decisions that will fundamentally affect the business. Since the business is generally the owner's principal asset, these daily issues can be all-consuming.

The owner's goal is to build a company that can either be passed on to his or her heirs or sold to liquefy assets. As you know, growing a business is difficult and cannot be achieved alone. Yes, you may be the leader, but you need a team; lawyers and accountants are integral members of that team, as are your lenders. Still, in many cases, this team can take you only so far with the execution of your strategy. The introduction of additional capital, whether in the form of debt, equity or a combination of the two, can provide the fuel to help propel your business forward.

Importantly, private equity firms provide more than capital. The additional value that a private equity firm can bring includes management and HR expertise, lending relationships and buying co-ops, as well as board insight and financial discipline that can be transformational. On the other hand, unless well-planned, the introduction of a private equity firm can also be intrusive. The preparation for taking on this type of partner in your business can be overwhelming, distracting and often bewildering. Fortunately, with an experienced team and preparation, you can reduce (although not eliminate) the frustration and anxiety—*and* increase your return.

Preparation for working with a private equity firm is not limited to the business. Although a business owner may have a long-term business strategy and may be executing a tactical strategy that includes funding of some description from a private equity firm, in many cases, he or she does not have a personal financial plan. This is a missed opportunity: The planning for the private equity process should always include a wealth planning component. In fact, it is essential to take a holistic approach to the entire wealth creation process.

The Duane Morris *Owner's Manual* provides a road map for business owners as they prepare to navigate the sea of change that will accompany the private equity and wealth planning process. As this area is highly technical and can be quite complex, we have provided a glossary of some of the terms used throughout this publication. We hope that our *Owner's Manual* will provide some initial guidance as you plan the next phase of growth for your company.

Sincerely,

George J. Nemphos

Chair of Corporate Practice Group and Co-Head of Private Equity

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Co-Head of Private Equity – UK/Europe

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Introduction

If you are the owner of a company, chances are you receive a regular stream of "cold" calls from private equity firms, competitors and strategic investors who want to talk to you about your business. Some of them resort to sales letters instead, inviting you to call them so they can tell you how they can make your very good company a great company. Some will tell you that you can liquefy a portion of your ownership in the company and continue in your operating role, if you desire, often while retaining some upside through continued ownership in the business or through the receipt of additional purchase price based on the business' achieving certain financial goals over a period of time, commonly referred to as an "earn-out."

What makes you so interesting to these investors? Over the last two decades, billions of dollars have been raised by middle-market private equity funds to invest in or acquire companies like yours. They are looking for mature, mid-sized companies with revenues of $10 million on the smaller end to $500 million at the larger end. Each private equity fund will target a certain size company, and many will further narrow their focus to certain industry sectors where the partners in the private equity firm have developed some expertise or in which one of their portfolio companies already focuses. Private equity firms already control nearly half of the middle market as measured by value, up from around 10 percent just 20 years ago, according to one estimate.[1] Chances are, you have seen some of your business associates or even competitors involved in sales to, or recapitalization by, private equity firms.

If you are ready to sell, you may be tempted to answer some of those solicitations. What if you are *not* ready to sell? What if you would like to take some money off the table and continue to grow your business? Or, what if you just want to survey the market and have some meetings to take the pulse of the private equity firms? Or, what if you, like so many owners of small- and mid-sized companies, are faced with a more complex imperative, such as the purchase of a smaller competitor, the desire to follow your largest customer into a new market or the need for additional capital merely to enable you

to grow your business? What if you do not have the knowledge, contacts, management capacity, bank credit or other resources to make it happen? Without help, you may not be able to take advantage of these opportunities. If you are not growing, you run the risk of losing market share—for instance, your competitors may access private equity capital and seek to attack your business—thus, standing still is most often not an option.

PRIVATE EQUITY MAY OFFER A SOLUTION

A few decades ago, your only choice may have been to sell the business before it was too late or carry on and hope for the best. If you were lucky and your needs were not too great, you might have been able to convince a bank to lend you more, or to find a silent partner willing to make an equity investment. With so many middle-market private equity firms offering so many different kinds of financial products as well as other support and value, including operating partners who have actually run businesses and managed through some of the challenges confronting you, business owners have a wide array of financing alternatives and access to varied operating roles.

No one has all the answers on how best to transition through such inflection points, but one thing is apparent: Answering cold calls is not the best way to find the right investor for you and your business. Even if you are not ready to sell, it is a good idea to understand your options and be well advised and prepared ahead of time. The best preparation begins more than a year before you are ready to put your company on the block or take in a major investor. Do not let your exit be an accident!

In our *Owner's Manual*, we discuss a range of options available with a private equity firm, touching on what would be gained and what would be given up in each scenario. We include a section on how you can prepare your company for an investment by a private equity firm and how to shop for the best advisors and investors. Of particular note, we also address wealth planning opportunities for the entrepreneur and his or her family.

Finally, an understanding of how private equity firms operate is vital before you consider taking capital from any of them. You always want to know from whom you are taking capital and the nature of their end game. The basic private equity firm structure is for the firm to form one or more "funds" as limited partnerships. The private equity firm then secures the funds that enable it to invest through capital commitments from such institutions as public pension funds, corporations, endowments and high net worth individuals, all of whom become limited partners in the fund. A fund generally has a life of 10 to 12 years, with the ability to extend for two years in order to conduct an efficient liquidation of its investments.

Private equity funds generally invest their capital in companies (such as yours), which they call their "portfolio companies," over a period of five to six years and generally look to sell, or "exit," four to six years after their initial investment. Exiting an investment permits the fund to distribute the proceeds of a sale to its limited partner investors. Funds vary in how they manage their investments in portfolio companies—from taking a totally passive role in the management of the portfolio company to playing an active role in day-to-day operations. You should ask for references from CEOs of other portfolio companies in which a particular private equity firm has invested, as well as ask the fund managers penetrating questions. You will be partners, just as in a marriage. You want to make certain that you know your potential mate.

Considerable capital is out there. You can have your choice of how much outside investment to take on to finance your growth, how much money to take off the table and what will be your future operating/management role in your company. There are myriad players and opportunities from which to choose. Here are a few points to start your thinking.

Partnering with Private Equity Firms

When should a company take capital from a private equity firm? As an owner, you have to ask yourself: What does it mean to partner with a private equity firm? What do I gain? What do I give up? There are times when an owner or a business reaches a crossroads, and money alone will not guide you in the right direction. Suppose the next logical step for your business means entering an overseas market that would stretch management to the breaking point. Suppose an obsolete plant or equipment is costing you business, but building a new facility or purchasing new equipment would entail more risk than you are willing to assume, whether or not the financing is available. Now, suppose carrying on business as usual without investing in new markets, new equipment and new technology would mean losing market share to larger competitors who are in a better position to invest.

For many mid-sized business owners, these sorts of dilemmas are more than hypotheticals. Markets change, and changing with them may be more than you want to undertake alone. This is what private equity firms look for: a business that could benefit not only from a capital infusion but also from the operational and managerial expertise that they are able to provide to their portfolio companies. Some private equity firms have overseas offices, enabling them to help outsource manufacturing and provide in-market contacts for their portfolio companies or possibly facilitate sales into those countries.

Partnering with a private equity firm may mean giving up a controlling interest, possibly economic and voting, in your company. It may mean gaining a partner that can not only provide professional oversight but also share the expenses and the risks of growing your business—a risk that many business owners tend to underestimate. If you are like many entrepreneurs, you have a significant portion of your net worth tied up in your business. An investment by a private equity firm could provide a way to turn your hard work into liquid assets and diversify your personal financial risks.

THE DUANE MORRIS VIEW

Stuart Sorenson

In our experience working with business owners on their exits, private equity can present a puzzle. A private equity firm will be asking tough questions in areas you may not have addressed before. We're told frequently that's when we add the maximum value—not just negotiating and drafting agreements, but counseling owners in the run-up to what will be, in most instances, the single-most meaningful transaction of their lives.

PRIVATE CAPITAL TAKES MANY FORMS

As we will see in the next chapter, private equity firm investments come in many different flavors. For instance, there are non-control investments that are sometimes referred to as "growth capital" investments. There are control investments in which the private equity firm will acquire 100 percent of the equity and permit or require the management team to "roll over" or reinvest in the company. Under any scenario, keep in mind that, first and foremost, private equity firms are investing in management. This means you!

Depending on the purpose of the proposed investment and the needs of the company, you may also be able to negotiate how much equity and how much control you are able to retain. Just as the structuring of an investment by a private equity firm comes in a variety of flavors, so do private equity firms themselves. The kind of relationship you develop with the principals in the private equity firm will determine the nature and extent of the intrusion in your business. Selecting a private equity firm is key since you will be accepting more than capital—you will be receiving a new partner who will work to play a positive and constructive role in the execution of your business strategy. Because the funds are stewards of other people's money, the principals in a private equity firm are hands-on with the businesses in which they invest. It will be a brave new world for you. However, the combination of a

new partner, with capital, who plays an active role in your company, can be a very positive relationship.

THE GROWTH EQUITY MODEL

In a typical growth equity or non-control investment, the private equity firm and management will seek to agree on how to determine valuation, which is always an "interesting" exercise. Although several different methods are used to arrive at a valuation, including a discounted cash flow analysis, comparables or a multiple of earnings before interest, taxes, depreciation and amortization (referred to as EBITDA), private equity firms generally use adjusted or normalized EBITDA to value a business.

That is only the beginning of the process. The private equity firm will issue a term sheet or letter of intent, called an "LOI," that will be non-binding and will set forth the principal terms of the investment. The private equity firm will generally acquire a preferred security, which will provide for a dividend that will accrue, a return of capital plus a preference payment, and participation on a pro rata basis with all equityholders. The other principal terms typically include one or more board seats, as well as certain "protective" or "consent" rights, which will require the company to obtain the consent or approval of the private equity firm to certain material transactions, including a sale of the company and other fundamental transactions. These consent provisions can be intrusive and, for that reason, are usually heavily negotiated.

Another standard provision is called a "right of redemption," which refers to the right of the private equity fund to require the company to repurchase the fund's interest after a period of time (usually five years after the investment). Even though this is not a debt instrument, there is a "maturity date." Other provisions will be negotiated, too. In addition, an investment by a private equity firm may, or may not, include a debt component. Even though LOIs are non-binding, once they have been signed, it is very challenging to renegotiate issues covered in the LOI. The seller or company will lose a significant amount of leverage at this point.

If you are actively managing your company but are not yet ready to move on or retire—and you want to take some money off the table—private equity firms may also provide that opportunity in either a non-control or control scenario. In fact, because middle-market private equity firms look for a platform investment in an industry that they believe has the potential to grow, the addition of a private equity firm as an investor may provide you with the potential to manage a much bigger company. The type of company they usually seek is reasonably well-established and has the capacity to grow exponentially through acquisition. Then, they buy other companies in the same industry, with a strategy—for example, growing geographically or increasing market share. The math is simple: A bigger company can get better terms from lenders and suppliers and, when it's time to sell, a higher valuation in the market. To achieve that growth, private equity firms rely on executives and managers who know the business intimately. They are not interested in running your business on a day-to-day level; they want to invest in it (and, more importantly, in you and your management team), help make it better and sell their stake at a premium within four to six years. This strategy makes your potential "second bite at the apple" much sweeter.

If you are actively managing your company, but are not yet ready to move on or retire—and you want to take some money off the table—private equity can provide that opportunity.

Beyond Bank Borrowing: *Mezzanine Funds & Growth Capital*

Imagine you can take advantage of a transformative opportunity for your company. You need $10 million to realize your vision, but the bank is only willing to lend you $5 million. Fortunately, private equity firms are willing to provide growth capital in the form of mezzanine debt, growth equity or a hybrid of both. Each entails some cost to owners above what a commercial bank would charge, in exchange for the greater risk these investors are willing to take.

COMMERCIAL LENDERS

If you have the assets to secure a loan, debt financing may still be the best and least expensive option, even if it does not come from a bank. For instance, many private equity funds have added senior debt options (through what is called unitranche lending) to their lineups. These funds primarily provide leverage for investments by private equity firms.

Non-bank lenders are also willing to extend senior debt beyond a commercial bank's comfort zone. Finance companies such as CIT and GE Capital specialize in underwriting debt for closely held companies, usually at the larger end of the middle market. If you are looking to lease new equipment or if there is a real estate component to your investment and you will have the cash flow to cover a higher debt load, you may be able to fund your growth with non-bank senior debt. This has the advantage of keeping your equity intact, but may require personal guarantees. These non-bank lenders are also less understanding in downturns or "hiccups," which likely means more risk to you. While they do not charge much, if you do not perform, they expect you to fix it since they are not making enough of a return to fix it for you. However, other alternatives are available.

MEZZANINE DEBT

Mezzanine debt, as the name implies, sits in the middle of the capital structure, between senior debt and equity. Mezzanine lenders are private equity funds that raise money, from institutional investors and others, and they usually look for opportunities within a set specialty—either a group of industries, a geographic region or a certain size company. Mezzanine lenders lend their fund's money in the form of subordinated debt. They also often make equity investments in companies, along with other private equity firms.

Mezzanine debt may be the right option if the cash infusion means accelerating revenue growth well beyond what you could achieve organically and if . . . you want to sell it or list it within a few years.

In "unsponsored" deals, those without a private equity firm investing, mezzanine lenders seek to invest in profitable companies that can provide a payout within a few years—companies on the verge of a growth opportunity, about to go public or planning to cash out an owner in part. In "sponsored" deals, they work with commercial banks and private equity firms to provide a layer of funding on a specific project or deal.

A typical mezzanine loan will be structured with a five-year term, during which the company will pay "interest only" until maturity, when the principal will be due. The interest rate will typically range from 11 percent to 14 percent,[2] of which 10 percent to 12 percent will be interest payable in cash on a monthly basis and the balance will be interest payable-in-kind, or "PIK" interest. Mezzanine lenders may also charge up-front fees of up to 2 percent of the principal amount of the loan. As part of the agreement, mezzanine lenders generally secure observation rights on the board, and depending on a variety of factors, they may require a seat on your board. In addition, mezzanine deals usually involve an equity kicker in the form of a warrant. Where a bank earns money on interest and services, such as deposits and cash flow management, mezzanine lenders who sit below the senior debt lenders, and are thus in a riskier position, want to

participate in the upside that equity investors will enjoy—at least in the medium term.

In an ideal transaction, the mezzanine fund hopes to make a profit through a combination of current interest, the exercise of warrants, the sale of the underlying equity upon a sale of the business or by requiring the company to repurchase the warrants after a period of time. Most mezzanine lenders are not interested in becoming long-term shareholders in your company because they need to make distributions to their own limited partners. Mezzanine lenders do not lend to keep the lights on. Therefore, this is a good option if you need to fund a growth project with a fairly certain payout within a fairly predictable time frame, or even to take some money off the table. If, on the other hand, you are looking for total liquidation of your ownership in the company, or if your company requires rescue capital, mezzanine debt is generally not among the better options.

For a business that is comfortable with the provisions of a traditional bank loan, the terms of a mezzanine debt transaction may initially look aggressive. Is it worth it? Mezzanine debt may be the right option if the cash infusion means accelerating revenue growth well beyond what you could achieve organically or if you believe the investment would help you enhance the valuation of your company because you want to sell it or go public within a few years. The question you need to ask is: Will your business generate a return on the capital in excess of the cost of the capital?

THE DUANE MORRIS VIEW

David Bernsohn

When we help put together debt financing for transactions involving private equity, it would be illogical to assume that a business owner—or even an active private equity group that doesn't consistently participate in leveraged deals—would have a solid handle on state-of-the-market conditions or sophisticated, sometimes-novel financing types and terms. We make it our business to stay current and conversant and, in so doing, convey competitive advantages to our clients, on either side of a transaction.

GROWTH CAPITAL

Taking on an equity partner may be a more attractive solution than taking on debt for a company seeking growth capital, but it is a more expensive alternative. Some private equity firms have funds called "growth capital funds," with which they will make minority or non-control investments in a company. However, the terms may look very similar to what a private equity firm would demand if it were making a control investment. For instance, in exchange for a capital infusion, you may have to give up some ownership of your company and some board control. Keep in mind that while an investment by a growth capital fund is not debt, and therefore does not have to be repaid, private equity firms generally seek to exit an investment in four to six years. To achieve this objective, private equity funds generally make an investment in the form of preferred equity and negotiate a "right of redemption," which enables them to cause the company to replace them in five years or, in some cases, permit them to cause the company to be sold.

The Auction Block:
Finding the Right Buyer for Your Company

An entrepreneur can spend a lifetime building a business, and a family business can represent several lifetimes of hard work. But what can you do if there is no one to take the reins? Securing a financial future for one's family is a powerful motivation to sell a business, even for the entrepreneur who would prefer to die with his or her boots on. Moreover, most small and mid-sized companies are worth far more with an effective entrepreneur at the helm than they would be as part of an estate. Hence, succession planning issues are a driving force in the private equity deal community. In this regard, time is a negative factor for the business owner. It is far better to contemplate your options early, and from a position of strength, so that when you are ready to make a decision, you know what the next steps look like.

To potentially maximize the value of your business, and facilitate the investment or sale process, it is essential to assemble an experienced and seasoned team of advisors who can prepare you for the process. Your team can describe in detail the process of taking on a private equity firm as an investor and can, therefore, assist in setting reasonable expectations for the transaction. This planning exercise can prevent disappointment and reduce or largely eliminate some of the common frustrations with the process. An experienced team of advisers will take a holistic approach to the planning process and examine your goals for both the company and your family. The team should be composed of an investment banker, a lawyer, an accountant and a wealth planner. The importance of having a team that works together, supports the business owner and serves as a resource cannot be overemphasized. The process of preparing a company for a sale—engaging an investment banker, preparing the confidential information memorandum for distribution to private equity firms and others, conducting management meetings, negotiating the LOI, undergoing due diligence, negotiating a definitive agreement with all of its ancillary documents and closing the transaction—generally takes up to nine months. A seasoned team of advisors can add significant value to that process.

PREPARING FOR AN EXIT IS A TEAM SPORT

The selection of the team is generally a process in itself, and if the owner's lawyers and accountants are experienced, they can be invaluable in the process. For instance, the lawyer will initially be the quarterback in the selection process (sometimes called a "bake-off") for the investment banker. Once the banker has been selected, the banker and the other team members will devote a significant amount of time to designing an optimal sale process. They will review and evaluate questions like: Should the sale process for your company be a broad competitive-bidding process (a "full auction"), which is designed to draw the greatest number of prospective buyers? Or would a "targeted auction" in which bidders are limited to a narrow range of likely prospects, hand-selected by you and your investment banker, be a better option? Each approach has its own pros and cons. In any scenario, the drain on management resources will be significant, and it is another area in which the owner will have to prepare the company for the sale process.

The planning phase is key because many business owners going through this process discover they have priorities above and beyond finding the highest bidder. What will happen to key employees? What if you are reluctant to show your books to a lifelong competitor who expresses interest in buying your company? What if you still want a place in the business you have built, even if you will not control it?

The process, whether a full or targeted auction, will be designed to generate the best types of offers for your business, from several appropriate investors. The benefit: You will have some choice with regard to the future of your company, and you can be assured that you are maximizing value and getting the most favorable terms.

As an alternative to private equity firms (sometimes referred to as "financial buyers"), the sale process may include potential acquirers called "strategic buyers." Strategic buyers have capital resources such as lines of credit that will enable them to compete effectively with financial buyers. In fact, if a strategic buyer *needs* your company (as opposed to *wanting* it), a strategic buyer may pay more for a company than a financial buyer just to get it. However, if a strategic buyer merely *wants* your company, they may want it at a price or on terms not acceptable to you.

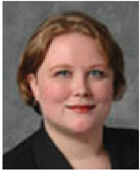
One of the principal differences between a sale to a financial buyer and a sale to a strategic buyer is that strategic acquisitions usually involve the acquisition of all the equity in a company. In that instance, your company will be acquired by the purchaser through a sale of all of the company's stock, a sale of all or substantially all of the company's assets, or a merger with the acquiring company. In each of these instances, you would not have any further ownership in your company. Closing a deal with a strategic buyer can also involve a certain level of internal bureaucracy, especially in a large corporation where approvals must be sought from their board and various departments that might be affected by the merger or acquisition of your company. However, financing is usually not an issue in a strategic acquisition.

THE DUANE MORRIS VIEW

Tom Redekopp

While we see financial buyers in the market all the time, we see just as frequently the other major force—strategic buyers. Since we handle M&A for a broad spectrum of mid-range and large corporations, we can provide owners with specific understanding of their priorities and the processes associated with each type of buyer. Business owners often tell us that this perspective is among the most valuable capabilities we can bring to the table.

THE DUANE MORRIS VIEW



Heather Carmody

It's rare that the process of selling a privately owned company is just a matter of facts and figures, although obviously it is essential to have a solid grasp of the fundamentals. More frequently, it's a pretty emotional process . . . largely because the owner is about to part with the work of an entire lifetime or, in some cases, many generations. We understand that for some owners, the continued success of the business and welfare of the employees (some of whom are not only critical to the business, but are also as close as family) can be as integral as the financial considerations of a sale. We strive to understand what is of utmost importance to a selling owner, and we put the owner's peace of mind at the top of our priorities list.

Selling to a financial buyer often provides the business owner with more flexibility than would a sale to a strategic buyer. In general, unless the sale is an "add on" to a private equity firm's platform portfolio company, the owner will usually be able to sell the company and "roll over" a portion of his or her equity so that the owner will have a "second bite at the apple" in four to six years, or at such other time when the private equity firm wants to exit the investment. This provides the owner with an opportunity to take some money off the table at the time of the initial sale to the private equity firm, continue to grow the company and then realize another payday when the company is sold a few years down the road.

Selling to a financial buyer also offers the most flexibility on deal structure and the best avenue to a future role for your management team.

ANOTHER EXIT ALTERNATIVE: THE ESOP

As you evaluate your exit options, some conditions could lead you to consider the Employee Stock Ownership Plan (ESOP) alternative. In one instance, you and your advisors may determine in the course of the sales process that market circumstances and the competitive environment do not favor what you consider an adequate valuation, and that the primary value of the company as an ongoing concern is to the workforce employed by the company. This is a complex transaction that involves significant financing, but can also provide important tax and other benefits. For the owner deeply invested in the welfare of his or her employees, an ESOP transaction can be an attractive option worthy of exploration.

Wealth and Estate Planning: *An Integral Piece of the Puzzle*

Whether you decide to exit entirely with a sale to a strategic buyer, sell a majority of your interest in the company to a private equity firm or exit through an ESOP transaction, up-front planning is vital for determining the structure and type of deal that will accomplish your goals with regard to both your business and your family.

Most, if not all, business owners are so consumed with starting, managing and growing their businesses that they ignore the consideration of estate planning techniques, which can substantially reduce the tax consequences imposed upon the death of its founder and principal shareholder. Personal estate planning is often overlooked by selling owners, but it is as essential as preparing your company for the sale process.

Although estate planning and the associated tax considerations frequently add another layer of complexity when considering the sale of an interest in a business, the benefits can far outweigh the time-consuming nature of this activity. Consideration of estate- and tax-planning techniques can force a business owner to seek the most comfortable (or least uncomfortable) balance of potential tax savings, loss of control and willingness to allow potentially significant parts of the sale proceeds to pass to, or for the benefit of, family members.

It may be appropriate for you to consider a family limited partnership, a trust or some other wealth transfer vehicle that may, among other benefits, transfer interests in your company at a discount to your family members while you continue to maintain control of the entity. Preparing and planning for the introduction of new investors into your business or the ultimate sale of your business, although daunting, also presents an opportunity to address family issues and strategies to maximize the net after-tax proceeds of income that you receive from the sale of all or part of your company.

Estate-, tax- and wealth-planning techniques are most effective when considered and implemented as far as possible in advance of a transaction involving the sale or disposition of a business, in whole or in significant part, and well before the valuation process begins with the investment banker and the private equity firms. A wealth planner plays an integral role in this process and should be a member of your team of advisors.

First Steps:
"Don't Let Your Exit Be an Accident"

THE DUANE MORRIS VIEW

Michael Grohman

The sale of any business is fraught with tax implications. A business that is privately or closely held, family-controlled or owned by a small group of partners is intensely personal for many reasons, not the least of which is the potentially complex impact on each owner's personal wealth and estate planning strategies. Often those strategies will present concerns not previously known or considered when combined with the possibility of a sale of the business. We work hand-in-glove with our transactional and financing lawyers to develop terms and structures designed to yield optimal advantage for individual owners by navigating the substantial challenges that come into play in anticipation of the closing of a sale transaction.

THE HUNT: HOW PRIVATE EQUITY FIRMS FIND YOU

Whether or not you are interested, a number of private equity firms would likely want to get to know you better. Some private equity firms employ business development professionals whose sole role is to find potential companies that fit a particular investment strategy, so you will probably hear from them on cold calls or see them at trade shows or other industry events.

Most are more targeted than that, however. They may already have investments and expertise in your industry. They may own one or two of your competitors. They may maintain relations with investment bankers who would also like to work with you.

Even if you are not considering a sale now, you can hear their pitch and learn something about the other companies in their portfolios. Most investment bankers and private equity principals are happy to speak with business owners, even if they are not for sale. If private equity is a growing presence in your industry, a little knowledge can go a long way.

What if you want to hunt for the right partner, either to sell to or invest in your company? As discussed above, the team you assemble will lead the hunt. An experienced investment banker will know your industry and the financial and strategic buyers that

would be interested in speaking with you. Taking this proactive approach gives you greater and earlier visibility into possible options, along with better control over the process. The time when you have the most leverage is when you are picking your partner . . . and it is always better to be the hunter rather than the hunted.

PREPARE YOURSELF

Before you approach any potential investor, it is a good idea to assess what you expect from a deal and whether or not your potential partner shares your goals. This is another area in which consulting with your advisors can smooth potentially rough waters. Many astute owners also save themselves considerable grief by hiring an accounting firm early in the process to do a readiness assessment, which should include a quality-of-earnings review. Meeting with your team provides an opportunity to cover everything from whether or not co-owners have realistic expectations for what a deal will accomplish straight through to what a buyer or investor is likely to uncover while conducting due diligence. Sorting out any potential issues ahead of time can expedite the process later on, as well as help prevent nasty surprises after a letter of intent has been executed.

As we discussed above, one number that matters greatly to private equity firms is EBITDA, which is earnings before interest, tax, depreciation and amortization. Many entrepreneurs may not focus on their company's EBITDA, but for a private equity firm, EBITDA is the principal method for determining valuation and whether your company is a good fit for their portfolio. For instance, a private equity fund with an average investment size of $100 million is unlikely to be interested in a company with an EBITDA of $2 million, unless it is for an add-on investment to bulk up one of their primary platform portfolio companies. EBITDA is also one of the numbers used to assess risk, determine how much leverage can be applied to a deal and establish a valuation for your company.

When determining EBITDA in the sale context, this number will be "normalized" or "adjusted" to add or subtract those income or expense items that are not "ordinary course" items. For instance, items such as one-time litigation expenses and owner's perks will be added back to increase EBITDA. This adjusted number will be the subject of the quality-of-earnings review that the buyer's accounting and financial consultants will perform as part of their due diligence. Any private equity firm interested in making an investment in your company will also undertake an extensive market study of your company and the industry or industries in which you operate, and its lawyers will perform an intensive legal review.

Buyers, in general, will scrutinize your income statement and balance sheet, assessing the quality of your earnings and focusing on working capital issues in particular. They will analyze many issues throughout this process. With regard to intellectual property, they will analyze whether you own the intellectual property used by your company, what intellectual property is leased and the importance of that intellectual property to your overall operations. They will assess your management team—the team you *have* versus the team you *should* have. Advance warning: Many private equity firms have noted that the manager most often missing in action is the CFO. Even if you love your part-time bookkeeper or you think it is not worth the expense, your company will look more attractive to an investor if financial controls are set up by a professional. The lesson: A good financial executive should pay for himself or herself. Also, audited financial statements, instead of compilations or reviewed financial statements, make a significant difference in a private equity firm's analysis of your financial position. Other housekeeping issues, such as taking the time to put your contracts, leases and other agreements in proper order, will enable you to project a positive image to prospective investors.

STRATEGIES

To attract a range of buyers, you should consider what really matters to your potential bidders. Whether you are thinking about positioning your business to be more attractive to a strategic buyer or a financial buyer, you may want to start thinking about what your company can do that no one else can—whether it's a product, a process or personnel. For a strategic buyer, one question to ask yourself is: What is it that would make a company that already does exactly what you're doing want to pay a premium to buy your company? Whatever that is for your business, focus on that, continue to grow that competency and stay laser-focused on those areas where you can deliver better than anyone else.

Buyers are also attuned to the risks associated with your business. Identify what keeps you up at night. Whatever the risks are in your business, think about how you can mitigate them. Among other issues, supplier interruptions, key personnel issues, unexpected customer defections and competitive technology innovations can all play havoc with an established business. Remember, no battle plan ever survived contact with the enemy. Think about how your business could survive and flourish should one of those risks come to pass. This is another area in which your team may be able to help you evaluate your business in advance of a sale or investment.

When private equity firms look at your company, they will find those same risks and worry about them even more than you. They are not as up to speed with your business as you are, so they will never be as comfortable as you are with those risks. The risks that exist with your company will come into play when a potential investor is ascribing a value to your company.

CHOOSING YOUR TEAM:
IT STARTS WITH THE RIGHT LAWYER

Before you approach the process, you should have an experienced lawyer who will represent your interests in all aspects of the process, from planning to structuring, and from negotiating to closing. However, your best bet will be a lawyer (and law firm) that has been to this rodeo before; if your legal counsel is your family attorney, you may not be getting the best advice for this kind of a transaction. If you have good counsel, they will do more than draft legal documents for you; they can provide introductions to investment bankers and business brokers. Also, they know what is standard for the process and "market" for transactions, and can thus allay fears of the unknown, which may unnecessarily undermine the achievement of your goals. Therefore, start early, take your time, get recommendations and interview prospective legal teams. Do all the things you would do if you were picking a new supplier or hiring a manager.

If you have good counsel, they will do more than draft legal documents for you; they can provide introductions to investment bankers and business brokers.

A good law firm can also help with wealth planning. The law firm will be able to advise you on whether you can minimize capital gains and gift and inheritance taxes, possibly by changing the equity structure of your company before you sell. Give yourself as much time as possible to consider and execute your wealth planning strategies. Remember, a planning process that starts at least one year in advance, and perhaps longer, is recommended in most instances.

CHEMISTRY CHECK

If you decide to use an investment bank to shop your business, you should go through an interview process that is equally rigorous. Choosing an investment banker based on which one hints at the highest valuation could prove a mistake—after all, the banker does not set the price; the market does. It is vital that the chemistry feels right and that you are confident in his or her abilities, and that he or she can and will devote their time to your company. Since it can take one year from start to finish, on average, to close a sale, you are going to get to know your investment banker really well . . . so make sure it is someone with whom you want to spend time.

If you are going to partner with a private equity firm—especially if you will have a continuing equity and management stake in your company—you will want to know even more about that firm. Ask for the names of the last five entrepreneurs with whom a private equity firm has worked, and get in touch with them. What was their experience in working with this firm? What happened when things were tough? What would they have done differently? Ask to speak with owners and management of bad or failed deals.

These steps to educate yourself and prepare your company for a major investment or a sale will take time away from the day-to-day operation of your company. Is it worth the effort? Many serial entrepreneurs have learned, through trial-and-error experience, that it makes good sense to run a business as if it is always for sale, even if it is not. If you are always prepared for a sale, you can take advantage of any opportunities that may present themselves and shouldn't find yourself without options. This, among many other good reasons, is why a key piece of learning here is: Prepare now and don't let your exit be an accident.

Glossary

BAKE-OFF – A competition (sometimes called a "beauty contest") among investment banks to be selected as the advisor to a company for an offering, financing, sale or similar transaction.

CLOSING – Closing is the date on which a transaction, whether debt or equity, is completed.

CONFIDENTIAL INFORMATION MEMORANDUM (CIM) – A confidential information memorandum, or CIM, is a detailed disclosure document delivered to potential investors in a private equity transaction that provides information on the company. It is similar to a private placement memorandum used in a securities offering.

CONTROL INVESTMENT – The purchase or acquisition of a majority interest in a business for the purpose of gaining economic and voting control of a company.

DUE DILIGENCE – The act of performing an investigation (legal and business) of a business entity, person or party in preparation for an acquisition or loan transaction or to verify the accuracy and completeness of an offering document.

EARN-OUT – An earn-out is contingent additional purchase price paid to a selling owner, the amount of which is based on the business' achieving certain financial goals over a period of time following closing.

EBITDA – Earnings before the deduction of interest, taxes, depreciation and amortization. EBITDA is a non-GAAP calculation based on data from a company's income statement used to measure a company's available cash flow. It is useful for measuring a company's operating cash flow and for comparing the profitability of various companies with different capital structures and in different tax brackets.

EMPLOYEE STOCK OWNERSHIP PLAN (ESOP) – A defined contribution plan that is designed to invest primarily in employer stock. An ESOP is generally used as a financing vehicle to purchase the founder's stock.

FINANCIAL BUYER – A private equity firm that utilizes the capital in its various private equity funds to purchase an equity interest in a company, or the entire business, as distinguished from a strategic buyer.

LETTER OF INTENT (LOI) – A non-binding document that sets out certain terms of a transaction agreed to in principle between parties that is negotiated and signed at the beginning of a transaction. Although not legally binding, an LOI may contain certain non-economic terms that are legally binding.

MEZZANINE DEBT – A debt obligation that ranks in priority behind senior debt but ahead of equity; often unsecured, high-yield, subordinated debt and commonly convertible into equity of the borrower.

NON-CONTROL INVESTMENT – The purchase or acquisition of an interest in a business without gaining economic and voting control of the company, although the investor generally has the ability to exercise control over certain major corporate decisions.

PORTFOLIO COMPANY – A portfolio company is a company in which a private equity firm has invested.

PREFERRED SECURITY – A class of equity security in an entity that typically entitles the holders to certain preferences and rights over the common holders, such as the right to receive dividends and the right to receive priority distributions upon the entity's dissolution or liquidation.

PRIVATE EQUITY FIRM – A private equity firm is an investment manager that makes investments in privately owned operating companies. These investments are typically made through a "fund," which is most often a limited partnership that has been established by the private equity firm. Each fund raises money through capital commitments from various investors, such as public pension funds, corporations, endowments and high net worth individuals, all of whom become limited partners in the fund. The private equity firm will manage one or more funds, each of which will have particular criteria for the portfolio companies included in that fund.

PROCESS – The activities in which a company engages in connection with a capital transaction, such as a "sale process."

QUALITY OF EARNINGS – An assessment of the true earnings of an entity by examining recurring and non-recurring items, non-business related expenses and similar items.

STRATEGIC BUYER – An operating company making an acquisition for strategic rather than investment reasons. Generally, a strategic buyer operates in the same industry as the company it is looking to buy.

NOTES

[1] Richard Trottier, *Middle Market Strategies: How Private Companies Use the Markets to Create Value*, page 88 (John Wiley & Sons, Inc. 2009).

[2] Skitch Investment Banking Quarterly Middle Market Report, Spring 2012, page 4.

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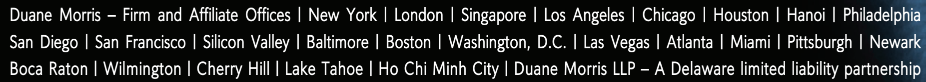

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