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CPA's basic guide to mergers & acquisitions

Ronald G. Quintero

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American Institute of Certified Public Accountants

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FOREWORD

Mergers and acquisitions continue to play a vital role in business strategy. Each year thousands of accountants, lawyers, investment bankers, and business executives are involved in various stages of mergers and buy-outs that result in the transfer of billions of dollars.

The experienced financial professional can play a vital role in this exciting and dynamic process. Whether the CPA serves as an outside auditor or consultant, or is a member of the management team of the company involved in the merger, acquisition, or divestuture he or she will need the comprehensive understanding of these processes that this book provides. Examples, analyses, and checklists drawn from actual transactions provide useful workproducts that can be applied by the CPA.

The author of this book, Ronald G. Quintero, CPA, CMA, CFA, is a Managing Director specializing in mergers and acquisitions at the management consulting firm of Chartered Capital Advisers, Inc. He is also a partner at its turnaround advisory affiliate, R.G. Quintero and Co. Both are located in New York City.

Mary Schantz
Vice President, Product Development

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CHAPTER 1
INTRODUCTION TO MERGERS & ACQUISITIONS

OVERVIEW

The objective of this book is to provide you with a basic understanding of the merger and acquisition process. We will approach mergers and acquisitions from the perspective of the buyer, the seller, and the professional. The topics covered include:

- Identifying acquisition candidates;
- Conducting due diligence;
- Structuring and negotiating transactions;
- Preparing a company to be sold;
- Pricing the company;
- Accounting and tax considerations;
- Financing the purchase; and
- Closing the transaction.

THE TRANSACTIONS

As we speak there are thousands of accountants, lawyers, investment bankers, and business executives involved in various stages of mergers and buyouts. These transactions will result in the transfer of billions of dollars which will directly and indirectly affect millions of people. The mergers and acquisitions activity has assumed a significant role in today's economy. In recent years, the amount of capital committed to mergers and acquisitions has reached record proportions. To give you an idea of growth in this area, *Mergerstat℠ Review* indicates that the aggregate transaction value of all reported mergers and acquisitions in 1974 was $12.5 billion. According to the most current figure available, in 1997, this amount had swelled to more than $657 billion. This dollar amount exceeds the gross domestic product of all but a few nations in the world. Increasing domestic and global competition, technological change, a need for capital by growing companies, corporate restructurings, and the globalization of the world economy have assured that mergers and acquisitions will continue to occupy a critical role in business strategy.

Setting aside the macroeconomic explanation for mergers and acquisitions, there are many more immediately compelling reasons why transactions occur. They generally fall into one of a few major categories:

- Horizontal combinations—where companies seek growth by combining with another company in their industry;

- Vertical combinations—where companies seek growth by combining with a company which is either a supplier or user of its products or services;

- Diversification—where companies seek combinations with companies in entirely different industries; and

- Investor buyouts—where investors purchase a company and operate it as a standalone entity.

The buyers include: individuals; managers; investor/operators; investment groups; public and private companies; and employee groups. Sellers include private sellers seeking to obtain liquidity; corporate sellers interested in divesting business units; and publicly-held companies.

There are a few critical hurdles which constitute the major milestones of the mergers and acquisitions process. The chronology and degree of effort may vary in each transaction, but the key activities include:

- Identifying the acquisition target;

- Initiating a dialogue with the target to establish its receptivity to a potential transaction;

- Performing an in-depth review of the acquisition target;

- Pricing the transaction;

- Structuring the transaction;

- Negotiating the transaction;

- Obtaining financing; and

- Closing the transaction.

They are depicted graphically in Exhibit 1-1.

THE PROFESSIONALS

Each of these activities involves representatives of both the buyer and the seller. Depending on size and complexity of the transaction, the network of people involved can be quite extensive. Some of the key people may include management, the board of directors, shareholders, investment bankers, brokers, attorneys, accountants, appraisers, management consultants, financing sources, competing buyers, and regulators. In the purchase or merger of a publicly held company, this network of professionals expands to include proxy solicitors, depositaries, forwarding agents, arbitragers, public relations firms and financial printers. A brief summary of the roles of each party is contained in Exhibit 1-1. The amount of responsibility for the transaction that each of these individuals will assume depends partly upon their functional expertise, and partly upon the individual.

Management clearly should assume a prominent position in any transaction. After all, they are responsible for running the company, and will ultimately be held accountable if the transaction misfires. Management may not have the technical expertise to execute each of the tasks required to consummate a transaction. However, they should be involved in:

- Providing direction for acquisition efforts;
- Retaining and controlling professionals;
- Interfacing with the senior management of the acquisition target;
- Communicating the progress of activities with the board of directors; and
- Planning the integration of the acquired entity with their own company.

Typically, the role of the board of directors should be to guide management and to establish the overall direction of the company. The function of board members in acquisition activities is normally to:

- Establish a general strategic objective to initiate an acquisition or a sale;
- Advise or ratify during key stages of the process;
- Introduce professionals and financing sources to management; and
- Approve or reject a proposed transaction.

In closely held companies, senior management and the board of directors may be one and the same. In such situations, they will most likely be the primary shareholders. If shareholders are not closely involved with the daily activities of the company, they must be accorded due attention as a special constituency, since their support is required to effect a sale or merger. Management and the board of directors are ultimately serving as custodians of the shareholders' investment.

Investment bankers and business brokers are frequently involved in initiating, structuring, and negotiating transactions. They also may be involved in obtaining financing to complete the transaction. Investment banks are usually medium to large size firms, with the capability to underwrite securities. Business brokers may be individual practitioners, firms, or networks of brokers.

Attorneys are indispensable participants in the mergers and acquisitions arena. Their role includes assisting in negotiations, performing legal due diligence, drafting contracts, providing tax guidance, and rendering legal opinions.

The typical role of the independent CPA in mergers and acquisitions includes performing due diligence or businessperson's review services, tax planning, acquisition audits, reviewing and preparing pro forma financial statements and financial projections, and issuing comfort letters.

Many accountants are also able to render management consulting services, which may include:

- Valuation and appraisal assistance;

- Performing industry analyses;

- Preparing financing documents; or

- Highly specialized services such as technology evaluation, human resources planning, plant layout studies, management information systems, actuarial evaluation, risk management, environmental contamination assessments, and planning the integration of the merged entities.

Financing is an indispensable element of the mergers and acquisition process. Key players include investors, bankers, investment bankers, joint venture partners, and money brokers. The amount of financing and structure of a transaction may be established as a result of the presence of competing buyers.

Virtually all transactions are subject to some degree of regulation. In small transactions, that regulation may consist of little more than the filing of property transfer deeds and income tax forms. Larger or more complex transactions may be subjected to the scrutiny of the Securities and Exchange Commission, Federal Trade Commission, Blue Sky regulators or industry regulators such as the FDIC or the ICC in high-profile or public transactions, or transactions in certain industries.

Besides inviting the scrutiny of the SEC and the securities exchanges, transactions involving publicly held companies also tend to enlist the involvement of information agents or proxy solicitors to seek the support of shareholders, depositaries to tabulate votes, forwarding agents to receive tendered shares, public relations firms, and financial printers.

A host of specialists can be required to complete a successful transaction. The cost of enlisting the assistance of these professionals can be substantial. The would-be buyer or seller should be prepared to commit at least 5% of the transaction value to the fees and expenses associated with retaining properly qualified professionals and completing the transaction. A substantial portion of those funds may have to be committed prior to the transaction being consummated, without any assurance of a successful result. This expenditure ignores the cost of distracting valuable management time away from daily operations.

These costs are small when compared to the cost of relying on inexperienced professionals to navigate the potentially treacherous waters of mergers and acquisitions. Consider the upside of a successful buyout, and the downside of a poorly conceived one. Professional fees and expenses pale in comparison to the potential risks and rewards. The seller should be reminded that he can only sell his company once. Accordingly, a possible lifetime of labor should not be entrusted to inexperienced advisers.

As an accountant, you can either be one of the legions of specialists, with a narrowly defined role, or you can be a major force in the outcome of a transaction. For reasons of independence, you may prefer a narrowly defined role. However, unless you develop an overall knowledge of mergers and acquisitions, you may not even be given the option to choose.

* * * * *

In this first chapter we have provided an overview of the mergers and acquisitions process, discussed motives for mergers and acquisitions, and have summarized the roles of key participants in mergers and acquisitions.

EXHIBIT 1-1
MERGER & ACQUISITION MILESTONES

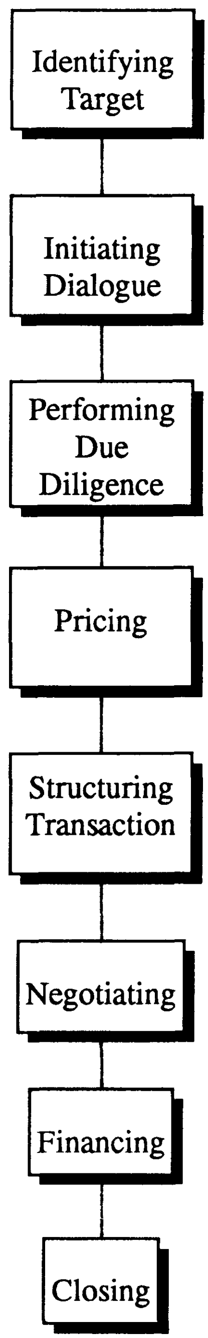


EXHIBIT 1-2
PRINCIPAL ROLES OF KEY M&A PARTICIPANTS

Accountants. Due diligence/businessperson's review; tax planning; acquisition audits; agreed-upon procedures; analyze and prepare pro forma financial statements and financial projections; comfort letters; management consulting.

Appraisers. Appraise assets for pricing the transaction, securing financing, and establishing tax and accounting asset basis; evaluate condition and marketability of tangible assets.

Arbitragers. Stock market speculators in M&A transactions.

Attorneys. Legal due diligence; title & lien searches; establish transferability of assets; draft contracts; issue legal opinions; tax guidance; regulatory assistance.

Board of directors. Initiate or approve directive for M&A program; approve retention of professionals; approve or reject transaction; provide introductions.

Capital sources. Vital to making the deal happen; include equity investors, commercial banks, institutional investors, junk bonds, ESOPs, and joint venture partners.

Company executives. Establish objectives; initiate activities; hire professionals; perform due diligence; negotiate transaction; integrate acquired entity.

Depositary. Tabulate votes in a public transaction; usually a bank.

Financial printers. Print proxy statements and tender offer documents for public transaction.

Forwarding agent. Receives tendered shares in public transaction.

Information agents/proxy solicitors. In public transactions: disseminate offering documents to "street name" shareholders and arbitragers; answer questions from target company shareholders; maintain shareholder lists; solicit shareholder votes; maintain and review transfer sheets to identify unusual accumulations of stock; communicate with "street name" shareholders through banks, brokers, and other nominees.

M&A intermediaries. Identify acquisition candidates; analyze company and industry; price, structure, and negotiate transaction; raise financing.

Management consultants. Industry analysis; valuations; technology assessment; human resources planning; actuarial analyses; management information systems; environmental assessment; integration planning.

Money brokers/investment intermediaries. Raise capital through debt and equity sources.

Other buyers. Create competitive atmosphere; may cause bidding war.

Private investigators. Develop information about target or buyer's senior management or board of directors; perform on-site investigations about issues such as drug problems on the workforce.

Public relations firms. Develop program to influence investors of their client's position.

Regulators. Review, and at times, must approve transactions; examples include SEC, IRS, FTC, state "Blue Sky" official, industry regulators (*e.g.,* FDIC); securities exchanges.

Shareholders. Approve merger; the ultimate sellers.

CHAPTER 2
MERGERS & ACQUISITIONS

INTRODUCTION

The urge to merge and desire to acquire are motivating forces in the human psyche. In this chapter we cover:

- The principal activities associated with initiating an acquisition program;
- Identifying, screening, approaching and analyzing acquisition targets;
- The differences between buying public and privately held companies; and
- Alternatives to mergers and acquisitions.

ESTABLISHING ACQUISITION CRITERIA

Before embarking upon a merger and acquisition program, it is important to have a realistic idea regarding your company's or client's prospects of doing a deal. Unlike the environment at the beginning of the 1980's when many of the great M&A tycoons were embarking upon their initial forays, today there is extensive competition for good deals. Few great companies are available for no money down at a purchase price representing a modest multiple of earnings. The amount of capital available to fund deals is greater than the supply of good deals. Finding and closing good deals today requires both hard work and capital. A would-be buyer who lacks either of these vital ingredients should reconsider whether he or she should even bother to get started.

A self-evaluation can spare the prospective buyer of what could be a fruitless pursuit. First, the would-be buyer should understand that the likelihood of stealing a good company is remote. There are too many other buyers beating the bushes for deals. With so much active interest, it is unlikely that sellers will be so naive as to part with their companies for less than what they perceive to be full value. That's not to say that bargains can't be had. However, a buyout program should not be dependent upon bargains.

Purchase prices will vary according to the unique characteristics of a company and its industry. A good starting point in assessing the financial requirements of an M&A program is a crude rule-of-thumb that good companies in most industries tend to sell for at least 50% of their annual sales volume. Also, the buyer should be prepared to commit equity to fund at least 15% of the total purchase price. Therefore, to buy a profitable company with $10 million in sales, you should expect to pay at least $5 million, of which at least $750,000 would be required in equity.

Additionally, as mentioned in the previous chapter, the transaction costs could be more than 5% of the purchase price, or $250,000. The buyer could expect to pay 20% to 30% of the transaction costs, or $50,000 to $75,000, prior to, and irrespective of, the deal closing. What this says is that a buyer seeking to purchase companies with sales in the neighborhood of $10 million should have access to at least $800,000 to $900,000 of equity capital which can be committed to the program, and probably more.

Available talent is more scarce than money. A buyer needs to have capable management to understand and run the acquired business. Depending upon the management of the acquired entity is risky. Studies show that senior management of acquired businesses tends to leave within two years of the buyout. Employment contracts are worthless if management isn't motivated and committed to devoting their best efforts to making the business successful. With a windfall of cash, or a change in owners, management may lose their former motivation. A buyer must have access to management which can be deployed to run the prospective acquisition candidate.

Assuming that the buyer has the capacity to do a deal, it is important to develop criteria for the acquisition search. Developing a reasonable set of acquisition criteria will provide a focus for acquisition efforts, and will avoid wasting time and money in an unstructured "buckshot" approach.

Exhibit 2-1 provides examples of questions to address in developing a set of acquisition criteria. The key decision makers of the company should be involved in establishing the acquisition criteria. After all, acquisitions can have a profound impact upon the strategic direction of the company. They generally represent the largest individual expenditures that a company is likely to incur. Since the decision makers' support will be required to consummate a deal, they should be involved up front in developing a composite portrait of the desired acquisition candidate.

To establish acquisition criteria, you should clarify your main objective in pursuing an acquisition strategy. Is the objective to diversify? Expand market share by acquiring competitors? Integrate vertically by acquiring suppliers or distributors?

If you plan to be active in mergers and acquisitions, it is useful to prepare an acquisition brochure. This provides background information about your company, examples of previous transactions, and most importantly, your specific acquisition criteria. The acquisition brochure is a marketing document which establishes your credibility and indicates that you are serious about doing deals. It can be used to introduce your firm to sellers. It serves as a useful reminder for acquisition intermediaries to differentiate your firm from the innumerable others which approach them every day in search of deals. If your list of acquisition criteria is specific, it is more likely that intermediaries will think of you when a relevant acquisition opportunity arises.

A large number of potential acquisition candidates can be eliminated by establishing some general parameters, such as industries of interest, minimum and maximum sales volumes of target companies, preferred geographical locations, and so on. A well defined set of acquisition criteria is a prelude to a screening process that looks like an inverted pyramid. You start with a universe comprised of all the companies in the world, which numbers in the tens of millions. You gradually narrow the number of feasible candidates to a manageable number through the application of acquisition criteria. This may, in turn, lead to a single company that uniquely satisfies your acquisition objectives.

ENLISTING ACQUISITION INTERMEDIARIES

There are several means by which you can get from the broad universe of potential acquisition candidates to the handful of likely candidates. You can go at it on your own; you can enlist the assistance of third parties; or you can do a combination of both. The importance of this step cannot be minimized, since it can greatly influence the end result.

The benefits of enlisting the assistance of merger and acquisition intermediaries may include:

- Functional expertise;
- Access to large numbers prospective sellers and sources of capital;
- Experience in distinguishing between companies that are really for sale as opposed to those seeking to find out what they're worth;
- Access to information sources;
- Ability to dedicate experienced staff to a project, without the distraction of day-to-day operating responsibilities;
- Independence from any political considerations which may influence the judgment of in-house staff; and
- Ability to preserve your anonymity during the initial overtures to the target company.

A buyer may consider going at it alone if:

- The aforementioned considerations are not relevant; or
- The acquisition candidate is already known to the would-be acquirer, perhaps being in the same industry, and there is reason to believe that no benefit would be derived from engaging an independent professional.

In such situations, the use of outside professionals may be limited to specific functional tasks, such as drafting contracts, performing acquisition audits, pricing the transaction, or developing tax allocations. Prior to coming to any conclusions, however, I would remind you of three adages:

- "You don't know what you don't know."
- "Marry in haste; repent at leisure."
- "He who is his own doctor has a fool for a patient."

Individuals working as merger and acquisition intermediaries are likely to practice through investment banks, accounting firms, business brokerage firms, commercial banks, management consulting firms, or they may work as sole practitioners. Large investment banks have traditionally been active in the largest transactions. During the past decade the merger and acquisition departments of the large investment banks have grown in size from a few members to staffs numbering in the dozens. They are particularly well suited for large transactions, international transactions, and deals where there is a need to quickly raise substantial capital. Some have also developed groups that specialize in certain industries or types of transactions, such as buyouts by Employee Stock Ownership Plans.

In recent years, several professionals have broken away from the large investment banks to form "boutique" investment banks. The boutiques and other types of merger and acquisition intermediaries are particularly active in transactions below $100 million in size. Regional investment banks tend to focus on transactions within their immediate geographical region, as do commercial banks. Many of the national accounting firms provide M&A services, with a strong orientation towards specific tasks such as due diligence and tax advisory assistance. Management consultants have also entered the M&A business in recent years. They often focus on specialized industries where they offer a family of consulting services, such as insurance or savings and loan associations. Brokers or finders are normally transactionally oriented. Their main role is matching buyers and sellers rather than performing the series of functional tasks required to evaluate and complete a transaction.

As in any professional service, you are engaging the firm rather than the industry, and the individual or individuals providing the service rather than the firm. Therefore, any generalizations must be weighed against facts specific to the individuals involved.

Intermediaries may charge on a contingent basis, a fixed-fee basis, an hourly or per-diem basis, or some combination of the above. The most commonly referred-to benchmark for establishing their compensation is the Lehman Formula, sometimes described as a "5-4-3-2-1 basis." According to the Lehman Formula, the intermediary is paid the sum of:

- 5% of the first million dollars of transaction value;
- 4% of transaction value between $1 million and $2 million;

- 3% of transaction value between \$2 million and \$3 million;
- 2% of transaction value between \$3 million and \$4 million; and
- 1% of transaction value in excess of \$4 million.

To give you an example, in a \$5 million transaction, an intermediary compensated based on the Lehman Formula would receive \$150,000. This is calculated as \$50,000 or 5% of the first million dollars in purchase price, plus \$40,000 or 4% of the second million dollars, and so on, up to a total purchase price of \$5 million. As the transaction grows in size, so do the stakes, although the work effort may not change proportionally. The saying is relevant that: "if it is just as easy to marry a rich man as a poor man, why not marry a rich man?"

Neither the cheapest nor the most expensive intermediary is necessarily the best. The attributes and capabilities of the intermediary must be matched with the needs and constraints of the prospective buyer. Chemistry is important. The intermediary must establish a favorable chemistry with both the buyer and the seller.

The ability to get one or several intermediaries to work solely on a contingent basis can be inviting. It involves little, if any, current outlay of cash. It only rewards performance. The drawback to pure contingent compensation is that intermediaries have a built-in conflict of interest. They are motivated to complete a deal, rather than to provide a full and unbiased range of advisory services. Also, an intermediary working solely on a contingent basis is likely to limit his involvement with each client, since his business depends upon presenting numerous opportunities to numerous, and sometimes competing prospective buyers. Many companies use intermediaries to identify deals and consultants and other advisers to analyze them.

Prior to engaging an intermediary, it is important to:

- Establish the scope of the services to be rendered;
- Determine the basis upon which fees become payable;
- Specify whether the arrangement is exclusive; and
- Clearly define "transaction value," since it more than likely determines the amount of fees to be paid.

Exhibit 2-2 provides an example showing several alternative ways that transaction value may be defined.

In addition to intermediaries, you should not overlook referral sources. These include accountants, lawyers, bankers, and other professionals which have business relationships with prospective sellers.

Their relationship of trust with the prospective seller can be a valuable introduction. The deal that they show you may not really be on the "selling block," therefore, less competitive. Unfortunately, their greatest concern is that they could lose a client. Therefore, they may be reluctant to set the wheels in motion which could disrupt the status quo. Also, they usually don't have a professional nose for sellers. Their clients may not be truly for sale.

FINDING DEALS

Whether you are working through a third party or performing the work yourself, you will be looking at a similar universe of investment opportunities. They include publicly held companies, privately held companies, divestitures from diversified companies, purchases of partial or minority interests, liquidations of assets, and venture capital investments.

In seeking out deals, the prospective acquirer can be opportunistic or proactive. The opportunistic buyer confines his acquisition search to companies known to be for sale that are presented to him by intermediaries and other unsolicited sources. The presumed benefit is that he is focusing his time on companies which have declared an interest in engaging in sale discussions. The drawback is that the number of companies known to be for sale is a very small minority of all companies. Many companies which have not expressed a desire to sell can quickly become available as a result of a reasonable offer and proper chemistry.

Deals may originate in many ways, including through:

- Intermediaries;
- Direct solicitations by the would-be buyer or seller;
- Personal contacts;
- Industry contacts;
- Professional referral sources such as lawyers, accountants or bankers; or
- Classified ads appearing in local newspapers, business publications or M&A publications.

A full-scale acquisition search involves more than simply responding to opportunities that are presented. It requires scouring the universe of available information to identify a short list of companies that will be contacted. The information sources used are likely to include:

- General reference sources, such as Moody's, Standard & Poor's, Dun & Bradstreet;
- Industry publications, such as trade association directories and product catalogs;

- Company data, such as annual reports and SEC filings;

- Online data bases; and

- People, including your management, sales staff, industry specialists, and others knowledgeable about your areas of potential interest.

One way of differentiating among acquisition search professionals is to ask about their knowledge of and access to information sources. These sources can have a major bearing on the prospects of success in difficult acquisition searches. A list of information sources which may be useful in performing acquisition searches is contained in Exhibit 2-3.

The acquisition screening process resembles panning for gold. The search begins with a seemingly boundless number of potential acquisition candidates, which is gradually reduced through the application of acquisition criteria. As an example, you may start out with more than ten million potential buyout candidates in the world. When you limit your interest to companies located in the United States, your universe of potential candidates is reduced by more than 80%. By restricting your search to a single industry, the list of candidates may shrink to 1,000 companies. A further requirement that they have sales between $5 million and $50 million may cause the number of candidates may be further reduced to 100. Applying various acquisition criteria will enable you to eliminate undesirable candidates and focus on those appearing to meet your objectives. You can gradually reduce the size of the universe to a manageable number of companies which you can scrutinize in greater detail.

SCREENING ACQUISITION CANDIDATES

The screening process assumes access to reliable information on all the potential candidates. Yet we all know that we live in an imperfect world. Most companies are privately held, and do not universally furnish all of the data that would be useful to your search. You must rely on data bases which do not necessarily draw on the same universe of companies, nor do they always classify them in the same manner. In comparing the list of domestic iron foundries between two directories listing 50,000 companies, you may find that 60% of the companies are listed in both directories. Yet they each list iron foundries not listed in the other publication. Or one may list a company as an iron foundry, whereas the other lists it as a steel mill. Upon further investigation, you may learn that both directories are wrong, and the company is actually a distributor of steel products. The data bases merely serve as initial screening mechanisms. No data base is perfect; several data bases should be used.

Once the universe of potential acquisition candidates has been reduced to a manageable number, which may range from ten to one hundred, the refinement process should continue. At this stage, the objective is twofold—to eliminate any remaining candidates found to be undesirable, and to prioritize the candidates for the purpose of making initial buyout inquiries. Those candidates which are not eliminated can be prioritized in terms of their relative degree of desirability based on a weighting system. The acquisition criteria which you have developed form the foundation of the weighting system. A weighting system applies subjective point values to each company based on its comparative conformity to various criteria. The weighting criteria may include items such as main line of business, geographical concentration of sales, reputation, sales volume, profitability, and a host of other factors. Some will clearly be more important than others, and will merit more emphasis. For example, the maximum points that you award to a company based on its geographical sales concentration may be three, whereas you may award up to five points based on its reputation. In some cases you may not have adequate data to evaluate a company in each of the criteria. Also, you may wish to apply subjective point scores to companies based on your general assessment of the individual company. The comparative total point scores of the companies would provide an indication of their relative degree of desirability. An example of the application of a weighting system is provided in Exhibit 2-4.

What will emerge from the weighting system is a prioritized "hit list" of acquisition candidates. Based on the point scores, some will clearly emerge as highly desirable candidates. Others will appear to have a limited degree of conformity with your acquisition criteria. The quality of the results of an acquisition weighting system depends upon the quality of the underlying data and the subjective judgment of the individual applying the weights. Ultimately, the weighting system should be a tool rather than a mechanical means of dictating a program. It should aid, rather than supplant decision making. The process of performing the acquisition search and applying a weighting system serves to focus acquisition objectives, educate the buyer about the participants in the target industry or industries, and provide a degree of assurance that the buyer is custom-tailoring an acquisition rather than merely picking one up off the rack. You will be able to concentrate your effort upon the company or companies that conform best to your acquisition objectives. You will not diffuse your efforts among companies which may not represent as good a fit. Like everything else in life, it pays, if you are going to do something, to do it right. Since there is an opportunity cost associated with most business decisions, and buying one company may preclude other actions and alternatives, it is preferable to buy the best company that you can find.

CONTACTING ACQUISITION CANDIDATES

Once you have established a "short list" of one or a few acquisition candidates, you are ready to initiate contacts. This stage should not be treated lightly. You only have one chance to make a first impression, and one chance to be told to get lost. It is important to do your homework about the company so that you speak from the vantage point of knowledge, and you can make the initial contact through the friendliest channel possible. Remember that the seller does not want to be viewed as just "another piece of meat." In a closely held company, the person running it may have devoted his career to the company, and be inextricably linked both personally and financially with the business. Publicly held companies are always careful about merger or sale discussions, since all material developments must be disclosed to the public. Any company will be concerned that rumors of a potential sale could disrupt business, and could be misused or misinterpreted by customers, employees, suppliers, or competitors.

Find out if a member of your acquisition team or a close contact, such as attorneys, or members of the board of directors, have an "in" with a senior executive, board member or professional serving the target company. The individual selected to make the initial contact should have as his objective to either engage in a preliminary dialogue about the desired merger or acquisition, or to open the door for such a conversation to take place. Discretion is obviously required, particularly if you have to get through one or more secretaries or other buffers to get to the responsible individual. Clearly, you don't want to announce to the switchboard operator to connect you with the president because you want to buy the company.

During the initial conversation you should establish whether the seller is genuinely interested in engaging in merger or sale discussions. While the seller will understandably be noncommittal in an initial conversation, you must attempt to ensure that the seller would be prepared to entertain a transaction on some reasonable terms. It is not uncommon for some business owners to be willing to talk with any prospective buyer, yet be either emotionally unwilling to sell, or willing to sell only on terms which are so exorbitant that they can never realistically be met. Conversely, it is not uncommon for owners to be unprepared to respond to serious acquisition inquiries, and to require a period of courtship to warm up to the idea.

Remember, time is an unrecoverable asset. You don't want to go down the path towards doing a deal, only to find that the seller is not really serious. In prequalifying a seller, you should establish that he has legitimate incentives for selling. The best motivated seller is one who is on life support. Short of that, considerations such as a lack of management successors or a desire to liquefy an estate constitute good grounds for selling a business. A company which has engaged a reputable intermediary has already demonstrated an initial commitment to sell. Another example of a motivated seller is a large company making a divestiture. Once the decision is made to divest, its execution is usually inevitable, often at any price that is attainable.

Once you have prequalified the sincerity and capacity of the seller, you need to obtain additional information which will enable you to confirm viability of the acquisition. If the company is being formally marketed by an intermediary or by management, there should be an information package that provides details about the company. An example of the contents of an information memorandum is contained in Exhibit 2-5.

More often than not, the company is not on the "auction block," and no such package exists. Using your judgment as to whether such a request can best be made over the telephone, or in an initial personal meeting, you should obtain some general financial information, product literature, and other data which would be vital to confirming your belief that the company is an appropriate acquisition candidate. Remember that your time and the target company's time is valuable. You don't want to waste it pursuing a deal that is never going to happen, nor to preclude a transaction at a later date by giving the impression that you are incapable of executing a transaction, or that you are a "tire kicker." Out of fairness to everybody, the early stages of your investigation should be directed to finding "deal breakers," that is, material items which are potentially so problematic as to virtually ensure that a deal cannot be concluded. Examples of deal breakers would be an insurmountable gap between your and the seller's view of the sale price or structure; large contingent liabilities; evidence of management dishonesty; or product lines and other target company attributes previously unknown to you that are inconsistent with what you are seeking to acquire.

Clearly, discretion has to be exercised in deciding how rapidly to forge ahead. Normally, it is best to proceed expeditiously in order to: maintain the momentum of the deal; demonstrate commitment to completing a transaction; and avoid losing the deal to a competing buyer.

DUE DILIGENCE

There are several levels of due diligence which should be performed. They include financial due diligence, operational due diligence, and legal due diligence. Financial and operational due diligence are often provided by CPAs as a single service under the title of "business review." The objectives of a businessman's review include:

- Identifying "deal breakers" which, if unresolved, could preclude pursuing the transaction any further;

- Verifying the information and representations received from the seller;

- Obtaining a more detailed understanding of the business; and

- Developing information which will be vital to negotiating a transaction, obtaining financing, getting board of directors approval, establishing the tax and accounting basis of the assets, and integrating the acquired entity into the buyer's business.

The businessperson's review also provides an excellent opportunity to develop a closer relationship with the seller and its personnel. An example of a businessman's review checklist appears as Exhibit 2-6.

The seller may require the prospective buyer to sign a confidentiality agreement prior to releasing detailed information. The agreement obliges the prospective buyer and his or her advisers not to divulge any nonpublic information received from the seller. It may require the prospective buyer and his or her advisers to return all materials, including notes and copies of documents, in the event that the transaction is terminated. The buyer should attempt to be flexible in signing the agreement, but should not sign anything which he or she does not intend to live up to. If need be, the confidentiality agreement should be revised and returned to the seller in a form that the prospective buyer can live with. Even with a signed agreement, the seller should recognize that the agreement will only be as effective as the good faith of the parties signing it. Violations of the agreement are difficult to prove, and will probably never be known to the seller.

A "letter of intent" or a written "expression of interest" often precede permission to undertake a due diligence review. Although the letter is nonbinding upon either party, it constitutes a general understanding between both parties on a number of important features of the proposed transaction, and may address:

- Price;
- Structure;
- Timing;
- Buyer's financing;
- Exclusivity; and
- Responsibility for fees and expenses.

The letter of intent is a formal indication that both parties are serious. It provides a basis for a transaction which will inevitably be modified as negotiations progress. It is an important way for both parties to determine whether they are proceeding on the same wavelength.

Due diligence often progresses in stages. The initial stage may constitute a one-day "sniff test," which subsequently is expanded by acquisition advisers and specialists. Issues may arise such as pension obligations or environmental problems which warrant hiring experts to review these very specific areas.

The cooperation and consent of the seller is absolutely vital. In many instances, due diligence must be undertaken on a discreet basis to prevent employees and outside parties from learning about the potential transaction. Care should be taken to avoid being disruptive, or unduly tieing up the seller's personnel. An understanding should be reached with the seller as to the nature of the investigation, timing, and the people who will be required by the buyer and seller.

It is not unusual for a seller to forbid inquiry into certain areas, particularly at the preliminary stages of an investigation. If so, you need to determine whether that information is immediately vital, or if it can be deferred until later. As both parties become more comfortable with each other, there should be a greater willingness to be more forthcoming. Otherwise, you will have to be prepared to inform the seller that you cannot proceed any further without that information.

The buyer should have one person who is responsible for monitoring the progress of the due diligence program, particularly if several parties are involved. It is important to maintain the momentum of the deal to make sure that the seller sees that you are serious, and does not change his or her mind about you or about selling the company.

The due diligence quarterback will make sure that no "deal breakers" are surfacing, and that the proper level of attention is being devoted to each area. Information obtained during the due diligence process will be the foundation for negotiations with the seller, and will contribute to answering the ongoing question of whether you should do this deal. Remember, far more deals fall apart than are completed, even after the signing of letters of intent. Any embarrassment of walking away from a deal is of far less consequence than the potential cost and losses from doing a bad deal. The adage that the first loss is often the best loss is most pertinent to mergers and acquisitions. At all times be prepared to walk away from a deal. Although investors don't make money by not doing deals, they don't lose money by not doing them either. Nobody ever went broke by not doing a deal.

There are noteworthy differences between acquiring publicly held companies and privately held companies or divested business units. The vast majority of transactions involve privately held companies or divestitures. These are usually negotiated transactions. You normally need to deal with just one or a few decision makers.

TRANSACTIONS INVOLVING PUBLIC COMPANIES

Buyouts of publicly held companies require satisfying multiple constituencies. They are costly and time consuming. You can attempt to negotiate a transaction with management and the board of directors or you can approach shareholders directly through a tender offer. You have to offer enough to induce public shareholders to tender their shares. Often negotiated transactions evolve into auctions or bidding wars once a public company is "put into play." Studies have found that the price/earnings ratios paid to buy publicly held companies are generally 20% to 30% higher than those paid to buy privately held companies. While some of that premium may be attributable to the generally more favorable characteristics that a company needs to have to go public, the premium reinforces the fact that you have to be ready to pay in order to play in the public arena. Also, there is no assurance of success—only of high professional bills.

ALTERNATIVES TO MERGERS & ACQUISITIONS

There are several alternatives to buying or merging with an existing company. They include:

- Buying options, warrants, or minority interests in a company, with the ability to increase your interest at a subsequent date;

- Entering into a joint venture with a company which has complementary attributes to yours in areas such as marketing, manufacturing, or technology;

- Buying specific product lines or assets;

- Hiring key individuals to start a new company, often referred to as a "greenfield" investment; or

- Entering into a marketing agreement, licensing agreement or manufacturing agreement.

* * * * *

A decision to embark upon a merger and acquisition program is really a decision to pursue expansion. There are several means by which that objective can be realized. Mergers and acquisitions constitute one approach.

So far, we have talked about evaluating your capacity to do a deal, identifying and screening acquisition candidates, approaching the candidate, performing due diligence, buying public vs. private companies, and alternatives to mergers and acquisitions.

EXHIBIT 2-1
DEVELOPING ACQUISITION CRITERIA

1. Motives for acquisition: Increase market share? Entry into a specific industry? Geographical diversification? Industry diversification? Product line diversification? Eliminate competitors? Shore up weak business? Bargain purchase price opportunity?

2. Businesses which are unacceptable: Purchase price? Size? Industries? Locations? Financial performance? Weak management? Management unwilling to stay?

3. Availability of resources: Management? Capital for acquisitions? Future capital infusions? Administrative support? Surplus production capacity?

4. Strengths and weaknesses of buyer: Management? Financial? Industry expertise? Marketing?

5. Industry preferences.

6. Geographical location.

7. Size: Revenues? Purchase price? Assets? Indebtedness?

8. Industry profile: One or a few major competitors? Numerous competitors, with no decisive leaders? Regional leaders? International competition?

9. Industry life cycle: Expansion? Maturity? Contraction?

10. Basis for competition: Price? Quality? Technological innovation? Service? Reputation? Marketing? Depth of product line? Convenience? Related products and services? Scale of operations?

11. Product or service profile: Commodity? Unique? End product? Component or input? Recurring purchase? Occasional purchase? Significant cost to customer? Significant element of customer's end product?

12. Capital investment: Recurring requirements? Machinery and equipment? Facilities? Research and development?

13. Employees: Skilled? Unskilled? Semiskilled? Unionized?

14. Scale of operations: One location? Numerous locations? Regional? Domestic? International?

15. Customer base: Consumers? Socioeconomic traits? Large companies? Small companies? Specific industries? Regional? Domestic? International?

EXHIBIT 2-1, CONTINUED
DEVELOPING ACQUISITION CRITERIA

16. Significance of regulatory environment?

17. Company's competitive position: Leader? Prominent company? Nondominant position?

18. Ownership: Public? Private? Divestiture?

19. Sources of financing to consummate purchase?

20. Structure of transaction: Purchase of entire company? Significant interest through capital infusion? Buy assets? Product line(s)? Merger?

21. Willingness or need to retain existing management?

EXHIBIT 2-2
EXAMPLES OF THE LEHMAN FORMULA
($000)

Description	Alternative #1	Alternative #2	Alternative #3	Alternative #4	Alternative #5
Price of common stock	$6,000	6,000	6,000	6,000	6,000
Funded debt		1,500	1,500	1,500	1,500
Maximum value of "earnout"			3,000	3,000	3,000
Employment contract				1,000	1,000
Trade debt					1,500
	$6,000	7,500	10,500	11,500	13,000
Lehman Formula fees:					
5% of 1st million	50	50	50	50	50
4$ of 2nd million	40	40	40	40	40
3% of 3rd million	30	30	30	30	30
2% of 4th million	20	20	20	20	20
1% of the rest	20	35	65	75	90
	$160	175	205	215	230

Comment: Each of the above alternative definitions of "transaction value" may be considered appropriate. The amount due according to the Lehman Formula depends upon the definition of transaction value. Accordingly, it must be precisely defined in an agreement with an intermediary.

EXHIBIT 2-3
A LIST OF USEFUL M&A INFORMATION SOURCES

Reference Works
Almanac of Business and Industrial Financial Ratios
Dun & Bradstreet Million Dollar Directory
Encyclopedia of Associations
Moody's Manuals (Industrial, OTC Industrial, OTC Unlisted, Bank and Finance, and Transportation)
RMA Annual Statement Studies
SEC filings, especially Forms 10-K, 10-Q, 8K, proxy statements, registration statements, prospectuses, 13-G, 13-D, 14D-1, 14D-9, 13E-3, and 13E-4
Standard & Poor's Corporate Record
Standard & Poor's Corporate Reports
Standard & Poor's Register of Corporations, Directors & Executives
Standard & Poor's Stock Guide
Thomas Register of Manufacturers
Value Line Investment Survey
Ward's Directory of the 51,000 Largest U.S. Companies
Ward's Directory of the 49,000 Largest Private Corporations

Merger & Acquisition Periodicals
Corporate Growth Report
Mergers & Acquisitions
Mergers & Acquisitions Report
Mergers & Corporate Policy

Online Services
America Online (financial information on public companies, stock prices, and other information)
Dialog (over 1,000 databases)
Disclosure Online (SEC filings and annual reports)
Disclosure/Spectrum Ownership (corporate ownership information)
D&B Credit Reports (financial information on more than 700,000 U.S. businesses)
Dow Jones News/Retrieval (stock quotes, articles from more than 3,000 periodicals, and financial information)
Investex (stock analyst's reports)
Moody's Corporate Profiles (news and background on U.S. companies)
Lexis Financial Information Service (company analysis and financial information)
Mergers & Acquisitions (M&A database)
Nexis (full text of general and business news)
Securities Data Corporation (M&A database)
Standard & Poor's (Corporate information, financial data, executive biographies, news)

Internet
Useful information sources are growing weekly
Bureau of Labor Statistics (economic data)
Daily Stocks (public company information)
Investing (US) (investment data links)
Invest-o-rama (public company information)
Mergerstat (M&A database)
Microsoft Investor (public company information)
SEC filings (SEC, NYU, Edgar Online, FreeEDGAR, etc.)
Wall Street Journal Interactive Edition
Wall Street Research Net (public company information)
Yahoo! Finance (public company information)

EXHIBIT 2-4
EXAMPLE OF AN ACQUISITION WEIGHTING SYSTEM

Criteria	Weighting	Co. A	Co. B	Co. C	Co. D
Desirable industry	4-2-0	4	2	2	1
Leveragability	2-1-0	0	1	1	2
Profitability	2-1-0	1	1	2	1
Geographical location	1-0	1	1	0	1
Estimated purchase price	2-1-0	2	2	1	1
Reputation for quality	2-1-0	0	1	1	2
Quality of management	4-2-0	0	2	0	4
Perceived synergies	3-1-0	3	1	1	0
Upside potential	1-0	1	1	0	0
Motivation to sell	3-1-0	3	1	0	0
Nonunion labor force	2-0	2	0	0	0
Total		17	13	8	12

Note: On the basis of the acquisition weighting scheme above, it appears that Company A most closely fits our acquisition criteria, whereas Company C seems ill-suited as an acquisition candidate. Ultimately, the weighting system should be used as an objective tool to enhance subjective judgment.

EXHIBIT 2-5
KEY ELEMENTS OF A TYPICAL INFORMATION MEMORANDUM

Overview
- Background of company
- Description of products or services
- Key advantages and selling points
- Financial highlights
- Motive(s) for the proposed transaction
- Structure of proposed transaction

Products or Services
- Description
- Competitive strengths and weaknesses
- Prices and unit volume
- Brands and trademarks
- Patent or copyright protection
- Research and development
- Regulatory issues
- Licensing and royalty agreements

Sales and Marketing
- Industry profile
- Competitive analysis by product and geographical market
- Seasonal characteristics
- Product gross margins
- Growth prospects
- Geographical sales breakdown
- Sales by customer categories
- Sales backlog
- Barriers to entry
- Sales and marketing methods used
- Standard terms of sale
- Major contracts
- Key customers
- Sales force compensation
- Physical distribution methods

EXHIBIT 2-5, CONTINUED
KEY ELEMENTS OF A TYPICAL INFORMATION MEMORANDUM

Purchasing and Production
- Product ingredients
- Suppliers and availability of alternatives
- Purchasing practices and procedures
- Standard terms of purchase
- Long-term purchase agreements
- Overview of production process
- Planning and scheduling
- Quality control practices
- Productivity data
- Identification of unique or advantageous production practices
- Cost accounting methods used

Facilities and Equipment
- Location(s) and demographic attributes
- Identification and descriptions of major assets owned and leased
- Favorable attributes of assets used
- Age and condition of facilities and equipment
- Assignability of leased property
- Repair and maintenance expenditures
- Comparison of appraised asset value and/or replacement cost to book value
- Production capacity and percent of utilization
- Expansion potential of existing facilities
- Comparative efficiency of plants and equipment
- Historical and projected capital expenditures
- Insurance coverage
- Surplus assets
- Physical security systems

Human Resources
- Analysis of employees by key classifications
- Key data on senior management and board of directors
- Willingness of management to remain after the transaction
- Employee management practices
- Compensation and fringe benefits
- Pension obligations
- Work shifts
- Key features of collective bargaining agreement (if applicable)
- Labor market
- Employee turnover

EXHIBIT 2-5, CONTINUED
KEY ELEMENTS OF A TYPICAL INFORMATION MEMORANDUM

Financial Summary
- Multiple-year financial summary
- Key financial ratios
- Capital structure
- Identification of a bank(s) and major creditors
- Working capital management
- Discussion of key financial issues
- Fixed and variable costs
- Identification of nonrecurring items and correctable inefficiencies
- Off-balance-sheet assets and liabilities
- Financial planning and control practices
- Description of management information system
- Major accounting policies and tax attributes
- Credit and collections
- Contingent liabilities and litigation in progress

Business Plan
- Description of business planning process
- Key elements of business plan
- Revenue growth, cash-generating and cost-saving opportunities
- Financial projection highlights and assumptions
- Capital structure after the transaction

Appendices and Exhibits
- Ownership structure of subsidiaries, partnerships, etc.
- Equity ownership percentages of major shareholders
- Identification of accountants, legal counsel and lead bank(s)
- Trading history of stock (if public)
- Marketing brochures
- Product brochures and catalogs
- Writeups from periodicals and trade publications
- Product sales agreement (for high ticket items)
- Photographs of facilities
- Listing of facility locations, descriptions and lease terms
- Equipment listing
- Asset appraisals
- Management organization chart
- Abbreviated management résumés
- Audited financial statements
- SEC or regulatory filings (if applicable)

EXHIBIT 2-5, CONTINUED
KEY ELEMENTS OF A TYPICAL INFORMATION MEMORANDUM

Financial projections
Payment terms of key financial obligations
Ageing of inventory and accounts receivable
Inventory analysis by product type and/or stage of completion
Examples of key management reports

EXHIBIT 2-6
EXAMPLE OF A BUSINESSMAN'S REVIEW CHECKLIST

General

___ When was the company or its predecessor started?
___ Legal structure of parent and subsidiary(ies)
___ Equity ownership percentages of all entities
___ Options and/or warrants outstanding
___ Names of accountants, attorneys and other professionals used
___ Previous owners
- Who are they?
- Why did they sell?
- What was the structure of the transaction?

Products

___ Description
___ Has the company always been in its current business?
___ Why has the product taken so long to penetrate its market? Is it a mature product?
___ Competitive strengths and weaknesses
___ Prices
___ Discussions with industry experts
___ Discussions with customers
___ Brands and trademarks
___ Patent or copyright protection
- Expiration date(s)
- Is it a vital competitive factor?

___ Research and development
- Who does it? What are they doing? How has the product evolved in recent years?

___ Are there any product developments likely to place this product at a competitive disadvantage?
___ Regulatory issues
- Which agency(ies)? How does the product approval process work?

___ Licensing and royalty agreements
___ Warranty liability
___ How are service and repairs provided? Who pays? How do practices compare to those of competitors?
___ *Brochures*
___ *Competitors' brochures*
___ *Product manuals*
___ *Royalty agreement*
___ *Articles on company's and competitors' products in trade journals and other periodicals*

EXHIBIT 2-6, CONTINUED
EXAMPLE OF A BUSINESSMAN'S REVIEW CHECKLIST

Sales and Marketing

___ Industry profile
___ Industry segmentation (by customer or function)
___ Competitive analysis by product and geographical market
___ Competitors
- General profile
- Market share
- Product traits (strengths, weaknesses, product features, prices, main markets, etc.)

___ Seasonal characteristics
___ Product gross margins
___ Growth prospects
___ Geographical sales breakdown
___ Sales by product categories and customer
___ Sales backlog
- What type of equipment?
- Is it profitable?

___ Barriers to entry
___ Sales and marketing methods used
___ Standard terms of sale
- Do deviations from standard terms occur?
- Is equipment made available on consignment?
- Are prospective customers allowed to use "loaners"?
- Are free trial periods allowed? Can equipment be returned?

___ Does the company assist customers in obtaining equipment leases?
___ Has the company gotten repeat business?
___ Sales force compensation
- What is annualized compensation at current sales levels?

___ How are sales professionals monitored?
___ Physical distribution methods
___ How are customers trained on the use of products?

Purchasing and Production

___ Product components
- What are they?
- Cost
- Sources of supply (just one or several?)
- Stock items or custom made to specifications?
- Labor and overhead?

___ Do total labor and overhead costs bear out unit cost analysis?

EXHIBIT 2-6, CONTINUED
EXAMPLE OF A BUSINESSMAN'S REVIEW CHECKLIST

Purchasing and Production, continued
___ Suppliers and availability of alternatives
___ Purchasing practices and procedures
___ Standard terms of purchase
___ Are suppliers allowing credit? Demanding COD?
___ Long-term purchase agreements
- Any up for renewal with possible major cost increases?

___ Overview of production process
___ Planning and scheduling
___ Is production for firm orders only or is inventory stocked?
___ Quality control practices
___ Productivity data
- Output per man-hour (does it vary significantly?)

___ Identification of unique or advantageous production practices
___ Cost accounting methods used

Facilities and Equipment
___ Facility characteristics
- Size
- Year constructed
- Construction type and materials

___ Identification and descriptions of major assets owned and leased
- Equipment listing

___ Leases
- Assignability
- Any price escalations upon assignment?
- Cancellability (especially Greenwich)
- Renewal date
- Current market value

___ Favorable attributes of assets used
___ Age and condition of facilities and equipment
___ Repair and maintenance expenditures
- Any apparent deferred maintenance?

___ Comparison of appraised asset value and/or replacement cost to book value
___ Insured value of fixed assets
___ Production capacity and percent of utilization
___ Expansion potential of existing facilities
___ Comparative efficiency of plants and equipment
___ Historical and projected capital expenditures

EXHIBIT 2-6, CONTINUED
EXAMPLE OF A BUSINESSMAN'S REVIEW CHECKLIST

Facilities and Equipment, continued
___ Insurance coverage
- How have costs changed in recent years?

___ Surplus assets
___ Physical security systems
___ Potential environmental problems
___ *Lease(s) on facilities*
___ *Insurance policies*
___ *Asset appraisals*

Human Resources
___ Analysis of employees by key classifications
- Identify job function(s) of every employee
- What skill levels are required for jobs?
- Are there sufficient workers with the required skills to grow the company?

___ Key data on senior management and board of directors (if any)
___ Is anybody likely to leave after the transaction?
___ Any seasonal fluctuations in headcount? Hiring and laying off according to production requirements?
___ Employee management practices
___ Compensation and fringe benefits
___ Pension obligations
___ Work shifts
___ Key features of collective bargaining agreement (if applicable)
___ Labor market
___ Employee turnover
___ Employee relations
- Has there ever been a labor strike? Slowdown?

___ Injuries and workers' compensation claims
___ *Organization chart*
___ *Employee handbook*

Financial Summary
___ Multiple-year financial summary
___ Projected cash receipts and disbursements, next 60 days
___ How promptly is key management information available?
___ Key financial ratios
___ Long-term capital structure
___ Identification of bank(s) and major creditors

EXHIBIT 2-6, CONTINUED
EXAMPLE OF A BUSINESSMAN'S REVIEW CHECKLIST

Financial Summary, continued

___ Bank debt (by institution)
- Nature of obligation
- Amortization schedule
- Interest rate
- Covenants
- Advance rates on credit lines
- Collateral
- Defaults

___ C. Co. Products
- Nature of agreement
- Validity and recourse of claims by owner

___ Working capital management
___ Fixed and variable costs
___ Identification of nonrecurring items and correctable inefficiencies
___ Off-balance-sheet assets and liabilities
___ Financial planning and control practices
___ Management information system
___ Major accounting policies and tax attributes
___ When was the last time that the company was audited by the IRS? Result?
___ Credit and collections
___ Contingent liabilities, unrecorded liabilities, and litigation in progress
___ Isolate and classify personal expenditures of Dr. A, last two years, as well as other nonrecurring expenditures
___ What is the nature of Long Island office accounts payable? Especially J. Brown, Esq.? Smith & Jones, CPAs?
___ Are payroll taxes current? Property taxes?
___ *Financial statements, last five years*
___ *Monthly interim financial statements, current fiscal year*
___ *Federal income tax returns, last five years*
___ *State income tax returns, last two years*
___ *Loan agreements*
___ *Detailed listing of inventory*
___ *Ageing of inventory*
___ *Detailed listing of accounts receivable*
___ *Ageing of accounts receivable*
___ *Detailed listing of accounts payable*
___ *Ageing of accounts payable*
___ *Examples of management reports*

EXHIBIT 2-6, CONTINUED
EXAMPLE OF A BUSINESSMAN'S REVIEW CHECKLIST

Business Plan

___ Description of business planning process
- Who is involved?
- How is plan used?
- How is the review and approval process performed?

___ Key elements of business plan
___ Revenue growth, cash-generating and cost-saving opportunities
___ Financial projection highlights and assumptions
___ How have past projections compared to actual performance? (verify)
___ How does current business plan compare to year-to-date results?
___ *Business plan*
___ *Financial projections*

CHAPTER 3
SALES AND DIVESTITURES

INTRODUCTION

For each buyer, there must be a seller. Otherwise, there will be no transaction. Since you can only sell your company once, you've got to do it right the first time. In this chapter we cover about motives for selling, how to go about the process, information that should be prepared, who to engage for assistance, and how to shepherd a deal to completion.

MOTIVES FOR SELLING

The majority of M&A transactions involve sales of privately held companies. They typically involve an entrepreneur or a small group of shareholders who have built up a company to a point where it may have substantial value. Its value may constitute the major portion of their net worth. However, an interest in a closely held company is an illiquid investment. The most common method of realizing that value is through the sale of the company.

The motives for a proposed sale often include:

- The entrepreneur wants to retire and has no family successor;
- Family members have inherited the business and lack interest in continuing to own or operate it;
- An investor group has operated the business, increased its value, and wishes to realize the capital appreciation through a sale;
- A belief that the company may have reached its peak value;
- The company has grown beyond the ability of the founders to manage it; or
- The company is experiencing financial difficulties, and requires an owner with turnaround expertise and/or deep pockets.

Divestitures occur for many of the same reasons as sales of privately held companies. These reasons include:

- A desire to raise cash or realize a profit;

- Lack of capable management at the subsidiary or division;

- A desire to eliminate businesses that don't match the strategic objectives of the parent company, or which do not produce satisfactory financial results.

Buyouts of public companies generally occur because the company has been "put into play" by a friendly buyer, or on a hostile basis, or because management or a major shareholder group has initiated an offer to take the company private.

Sales of companies can occur either on an opportunistic basis or as a result of a proactive program. The procedure for selling your company on an opportunistic basis involves waiting by the telephone for a good offer to come along. Assuming that somebody calls, you are guaranteed neither the highest price nor the best buyer.

DEVELOPING A MARKETING STRATEGY

Most companies that stay in business are not passive about selling their products. If a company is willing to be proactive in seeking a single customer order, it should be dramatically more so in seeking a sale of the entire company. A proactive selling program allows you to have greater control over the destiny of your company. A good starting point is to skip ahead to the end, and then afterwards to decide if it is worth going back to the beginning. As in all endeavors, formulating an end-game strategy is useful. Start by asking:

- How much do I want to realize from the sale of my business?

- What is it worth today?

- What would be the after tax proceeds if I were to sell now?

- What would I plan to do after selling the business?

- If the estimated after tax proceeds from selling the business today are less than my target, or if I am not yet ready to sell, what are the risks and opportunities involved in waiting to sell at a later date?

If the answers to the above questions lead you to the conclusion that you are ready to consider selling, then you should seek professional guidance.

The main services that you will require include:

- Establishing a target sale price range;
- Developing selling information;
- Identifying and contacting potential buyers;
- Controlling the selling process; and
- Negotiating the transaction.

Assistance may come from one or several sources. In most transactions of any substance, the functional skills of business intermediaries, accountants, and lawyers are likely to be required. They are likely to be employed by firms or in practices specializing in the relevant functional disciplines.

The sale effort will probably be launched by the business intermediary. The intermediary may be investment bankers at national or international firms, regional investment bankers, business brokers, or intermediaries employed at accounting firms, management consulting firms, or commercial banks. Unless your company is a billion-dollar company, the sale will probably depend upon the efforts of less than five people, irrespective of whether you engage a bulge-bracket investment bank or a three-man firm. The quality of the service and attention which you receive is dependent upon the individuals involved rather than the firm at which they work. This is a very personal business. As in any professional service, you must be comfortable with the experience and expertise of the individuals rendering the service. The same due diligence which you employ in selecting any other professional should be applied in selecting business intermediaries. You should review their qualifications, talk to references, request samples of their work products, and clarify the financial arrangement that they propose.

Most business intermediaries charge fees that are patterned after the 5-4-3-2-1 Lehman Formula that we discussed in the previous section. Some fees and expenses may be billed on a current basis, irrespective of whether or not a transaction is consummated. Exhibit 3-1 lists some of the key features to be negotiated in an agreement with a business intermediary. The main attributes that you seek are expertise and performance. The price of obtaining these is likely to be some current fees as well as an exclusive agreement. These may seem onerous in light of the fact that there are likely to be numerous business brokers who tell a good story and will offer to represent you on a contingent basis. However, as in anything that you buy, cheapest does not mean best. Some intermediaries make a good living by juggling 100 deals during the course of a year, in hopes that one or two will close. Others serve a limited number of clients, to whom they provide extensive service, with greater assurance of success. If you are committed to selling or receiving professional guidance, the latter type of business intermediary is probably best suited for you. If selling is merely a passing thought, then a nonexclusive, contingent relationship with a business broker may be appropriate.

Your business intermediary should be able to:

- Provide guidance on the current market for businesses like yours;
- Characterize the nature of the likely buyers; and
- Give you a range of the price and deal structures which are attainable.

If the business intermediary is capable and active on your behalf, and if your transaction expectations are realistic, you can generally expect a sale to take three to twelve months to consummate. Despite any assurances that your business intermediary may provide, a transaction on terms which are acceptable to you cannot be guaranteed.

As is the case with buying a company, you can circumvent using an intermediary altogether. This may be appropriate if you are confident in your merger & acquisition expertise, or it you know exactly who your prospective buyer is, and are confident that the buyer will offer you the best possible terms. In most instances, however, a good business intermediary should provide value dramatically in excess of the cost of his fees.

PACKAGING YOUR COMPANY FOR SALE

To bring your company to market in a professional manner, you need to develop a selling package. This will usually be prepared by the business intermediary. It will include information on:

- The background of the company and transaction;
- Ownership structure;
- Products or services;
- Market and competitive profile;
- Facilities and equipment;
- Management and employee;
- Financial performance;
- Brochures; and
- Other information that would be meaningful to prospective buyers.

A detailed information memorandum describing a company of at least $2-3 million in sales is likely to be 20 to 50 pages, including exhibits. Exhibit 2-5 lists the nature of information typically contained in an information memorandum.

Some sellers initially resist the notion of preparing an information memorandum. It takes time, money, and reveals information viewed as confidential. The reason for preparing it is that it is an efficient way to communicate important information in an objective, but favorable light. A well-done information memorandum speaks well for the company, and tells buyers that you are serious about selling. It spares the seller of having a legion of prospective buyers disrupt the business, ask the same questions, only to learn fundamental information that would normally be contained in an information memorandum. Many buyers choose not to deal with companies which lack professionally prepared materials. They are too busy to bother. Others make the effort to learn more, but quickly lose interest after they gain knowledge that would normally be contained in an information memorandum. The cost of not preparing an information memorandum is missing out on some good buyers, and wasting time on others that are ill informed about fundamental aspects of the business.

The concerns over confidential information that is contained in information memoranda are largely unfounded. First of all, a skillfully prepared information memorandum carefully navigates the boundary between providing sufficient information to elicit buyer interest and so much as to be detrimental if it were in the hands of competitors. Most information is fairly routine, and would be of little true benefit to competitors. Professional buyers recognize the importance of keeping confidential information confidential. Their reputations and future deal flow depends upon being good custodians of that information. Moreover, it will probably be of no use to them if they elect not to pursue the transaction. If you can't trust a prospective buyer with information, then you probably shouldn't deal with him. Information which is provided to direct competitors may have to be edited, and only released in greater detail as buyout discussions progress. Remember that any serious buyer has a right to request any and all information about the company. If the buyer is smart, he or she will eventually obtain all relevant information. The issue, therefore, is simply one of timing.

The financial information provided to buyers should reveal the true financial condition of the company. This is something that is not necessarily contemplated in generally accepted accounting principles or income tax returns. Assets are normally stated at their depreciated or adjusted historical cost, rather than at fair market value. Tax returns, especially of privately held companies, tend to understate profitability. Pro forma schedules should be prepared which enable the prospective buyer gain and understanding of the difference between the historical balance sheet of a company and the fair market value of its assets and liabilities. Off balance sheet assets such as bargain leases, favorable long-term contracts, low-interest loans, and other desirable assets and liabilities that can be conveyed to the buyer should be highlighted. A pro forma income statement should contain add backs such as unusual owner perquisites, one-time charges, and other items that are not indicative of the true earnings capacity of the company. Exhibits 3-2 and 3-3 provide examples of a pro forma operating cash flow statement and balance sheet. Don't view the prospective buyer as if he or she is an IRS examiner. You want to convince him or her of the merits of your business. If you and your advisers don't make them clear, then they are unlikely to be reflected in the purchase price. Even if the buyer discovers them, he or she will not pay for them if you don't point them out.

DEVELOPING THE SALES PITCH

Prior to initiating contacts with prospective buyers, it is important to be clear as to how you wish to present your company to prospective buyers. Any marketing message depends upon a very brief list of desirable attributes that will appeal to prospective buyers. Examples of these attributes would be:

- Proprietary technology in the widgets industry;
- The exclusive distributor of Brand X shock absorbers in Western Kentucky;
- The low-cost producer in the industry; or
- The only approved supplier of widgets to the U.S. Government.

You should figure out what the unique selling points of your business are, and list them on a piece of paper. The number should be no greater than ten. With those in mind, you should prepare a one-page summary of the information memorandum, making sure that the unique selling points are included in the summary. The purposes of the summary are:

- To have it as a focal point of your selling discussion;
- To provide it to some buyers as a prelude to releasing the information memorandum, so that they can determine whether or not they wish to receive it; and
- To serve as a synopsis for buyers that do receive the information memorandum.

Often the one-page summary is released to a broad audience by intermediaries without identifying the name of the seller. Those buyers or fellow intermediaries which express interest are then provided with the confidential information memorandum.

The information summary also assists in reducing your selling message to a few key points. Advertisers and human relationship experts say that most people form strong impressions within the first 30 seconds of any information exchange. Applying this to sales of companies, it is important to be able to summarize the key selling attributes of a company in a very brief discussion. Active buyers may receive 5 to 50 selling proposals per week. To effectively deal with them, you must be efficient in conveying your message. This discipline also applies to dealing with a corporate buyer, who may see far fewer deals. The corporate decision maker is probably a very senior member of the buyer's organization. Particularly if he doesn't know you, you will have to rapidly pique his or her interest.

At this stage you will also need to be able to convey a fairly clear idea of the potential sale price of the company and other key elements of the transaction, such as:

- Are you seeking an all-cash deal?
- Will key management remain after the sale?
- Is existing debt assumable by the purchaser?

Whereas rigid views on some matters may be premature, most experienced buyers will seek some general transaction parameters in order to assess whether you are serious, and in their price ballpark.

IDENTIFYING POTENTIAL BUYERS

Now that the company is all dressed up it needs someplace to go. The success of your program to sell the company depends upon efficiently identifying and contacting the right buyer audience. I once heard a frustrated buyout professional characterize owners of privately held companies as entrepreneurs who spend their first twenty years building up a company and the next twenty years attempting to sell it. Assuming that you are aspiring to complete a transaction within a more limited time frame, you should start by narrowing the field of prospective buyers to those most likely to complete an acceptable transaction.

To determine who the probable buyers are, you should put yourself in their position. Begin by focusing on the key selling points. Is your company likely to be of interest only to local buyers? Regional buyers? National buyers? International buyers? Industry buyers? Investment groups?

Study transactions that have occurred within your industry. You should be able to identify most transactions of any magnitude through the merger & acquisition data bases referred to in Exhibit 2-3, the reading list in Chapter 8, and through publications specific to your industry. An experienced M&A intermediary should also be helpful in this area. See who the buyers are of companies in your industry and related industries. Some of these buyers may be interested in your company. It is also useful to note whether the buyers are industry participants seeking to add products and territories, or investment groups seeking a transaction that makes financial sense. An understanding of who the probable buyers are will enable you to effectively focus your efforts where they are most likely to be productive.

The result of this process should be a prioritized list of potential buyers. To establish a basis for prioritization you should evaluate the potential buyers on a comparative basis. Factors that you should consider include:

- Financial capacity of the buyer to complete a transaction;
- Likelihood that the buyer will *want* to buy your company;

- Apparent ability of the buyer to effectively manage your company after a transaction;
- Compatibility with the buyer's organization and organization structure; and
- The likelihood that the buyer will entertain a transaction which is suitable to you.

Examples of buyer evaluation forms are contained in Exhibits 3-4 and 3-5. Since you probably will not have established contact with potential buyers at this stage, you will have to make some assumptions in order to develop a prioritized list. Don't overlook management in developing your list of potential buyers. Management is often the best buyer. They may have been covetous of the company for years, but simply reluctant to make the overture. Even if they lack money, a proven track record may enable them to get an equity partner to fund the purchase price. In many management buyouts of major companies, management puts up less than 1% of the total purchase price.

INITIATING THE CONTACTS

If you are simply responding to a buyout overture, rather than initiating a proactive program to sell the company, none of what I just said may seem to apply. You already have your prospective buyer. There is no apparent need to seek out buyers, or to prioritize them, since there is only one. However, if you are willing to consider selling to the party that approached you, then you should consider whether or not you should broaden the field of potential buyers. Restricting your company to one buyer is much like marrying the first person you date? Whether or not you choose to do so depends on who asks, and how good their proposal is. To evaluate that first proposal, it is often valuable to develop a frame of reference.

The window of time for initiating contacts with potential buyers should be relatively brief. Some sellers choose to approach buyers on a sequential basis, going first to the most desirable, then, if rejected to the next, and so on. This approach has two potential pitfalls: (1) buyers don't have the competitive sense of urgency or incentive to offer the highest possible price if they believe that they are the only buyer being contacted; and (2) if the campaign to elicit sellers takes too long, the deal becomes "shopworn." Many buyers avoid companies that have been on the market too long, believing that something must be wrong with the company if nobody has bought it yet. As a consequence, it is usually best to approach several prospective buyers simultaneously rather than a single buyer.

The nature of the approach and the individual making the approach will vary, depending upon the situation and the individuals involved. In a proactive selling program, it is normal to have the initial contact being made to a top executive, director, or professional representative of the buyer. The initial contact is usually made over the telephone. Before revealing too much information about the seller, you prequalify the buyer to determine his or her capacity and interest in pursuing a transaction. You always establish the confidential nature of the conversation, unless the sale is a well-publicized auction. Until you prequalify the buyer, you may choose not to reveal the identity of the seller. To supplement the conversation, you may provide the prospective buyer with a one-page summary of the seller, which may omit the seller's identity. At this stage, you may also give the buyer a general indication of the neighborhood of the target sale price in order to confirm that the buyer is capable of meeting it, and that there is not a major disparity between the buyer's and seller's perception of value.

The next step is usually to provide the buyer with the information package. Prior to, or simultaneous with, the release of the information package, you may wish to require the buyer to sign a confidentiality agreement.

How many buyers you approach depends upon the size of the universe of potential buyers, the motivating factors of the sale, and the desired time frame for selling the company. You may approach as few as one, and as many as several hundred. In today's environment, most properly qualified buyers will express an initial interest in learning more about a target. For a typical transaction involving a company with $10 million in sales with a national audience of prospective buyers, you may contact 50 potential buyers, resulting in the dissemination of 30 information memoranda, which in turn induce visits by 15 buyers, resulting in 5 letters of intent, in order to produce one party to buy the company. As the saying goes, you may need to kiss several frogs to find one prince.

Be encouraged, but not overly optimistic, because several parties have indicated an interest. To proceed to the next step, you need to distinguish between the tire kickers and those likely to proceed with a deal. Before allowing the buyer to schedule a visit, seek feedback regarding the company, why they are attracted to it, and again, possible pricing.

CONTROLLING BUYER DUE DILIGENCE

For the initial level of buyer due diligence, there are two approaches that are commonly employed—conducting an auction and promoting a carefully orchestrated sale. In an auction, you may set aside a room with a mountain of relevant data available for inspection. You may provide serious buyers a more detailed information package containing appraisals, union contracts, customer information, loan agreements, cost accounting data, and other important documents. A nonbinding letter of intent may be sought early on in the process. A problem with an auction is that it may draw a large crowd of potential buyers, and often discourages some of the best qualified buyers from participating. It is the antithesis of a carefully cultivated sale. However, it may result in the highest price, and it is normally the fastest route to completing a transaction.

If a more deliberate, negotiated sale is being pursued, then a trickle, rather than a flood of buyers, must be accommodated. Although less numerous than the hoard attracted to the auction, they are likely to place significant demands on the time of senior management. It is time consuming to deal with buyers. An initial visit may last a day or two. Follow-up visits and detailed due diligence are likely to require months of elapsed time, and hundreds of hours of management time.

During the due diligence process, it is important to manage both the buyer's and the seller's employees and professionals. Starting with the seller's employees, remember that they are important assets of the business. Whether you are dealing with buyers, bankers, or middle managers, one thing that they abhor is uncertainty. Employees who learn that the company is on the block often decide that it is time to update their résumés. They presume that the new owner is going to "clean house," and their jobs will be eliminated. Competitors often use the knowledge as a tool to raise customers' fears. The conventional wisdom is to only inform those employees who need to know that the company is for sale, and to insist that all involved, including the buyers' representatives, conduct their efforts discreetly. If you are a publicly held company, you cannot lie to the public or the media about whether or not your company is for sale. Just remember the phrase "no comment."

Buyers need to be provided with adequate information upon which to make an investment decision. However, you don't want to give them an education at your expense, or to go through a fire drill that is likely to be unproductive. The information provided must be sufficient to enable them to decide whether to go to the next stage of the buyout process.

Initially, the information memorandum should be sufficient to enable a buyer to develop a preliminary decision as to whether or not he or she is truly interested in the business. It also may be used to develop a preliminary and nonbinding indication of value and transaction structure.

Those buyers or that buyer able to pass through these screens should be allowed to delve deeper. If a buyer is not allowed adequate information, he or she is likely to either walk away from the transaction or reflect his or her uncertainty in a lower purchase price offer. You need to work closely with the buyer in order to ensure that:

- The due diligence program is proceeding on an orderly and timely basis;
- Information requests are reasonable;
- Proper information is provided in response to the information requests;
- The buyer is not being disruptive in pursuing his or her due diligence program; and
- The buyer is properly interpreting the information that he or she is provided.

Obstacles invariably arise during the due diligence process. Perceived problems may be detected by the buyer which must be mitigated in order to proceed. Specialists may have to be brought in to examine areas such as environmental issues or pensions and employee benefits. At advanced stages of due diligence, auditors may be brought in to review the financial statements. The cost of an exhaustive due diligence program can be high for both the buyer and the seller. Besides the out-of-pocket costs of the process, there is a substantial cost associated with the time of involving corporate personnel in providing and reviewing information. For that reason, it is not unusual for buyers or sellers to require breakup fees to reimburse them for out-of-pocket costs in the event that the other party changes his or her mind in pursuing a transaction. Sellers often require buyers to provide a nonrefundable deposit as evidence of good faith prior to permitting a detailed due diligence program to be initiated. On occasion, buyers may demand a commitment fee from the seller as a demonstration of good faith after signing a letter of intent. There are no absolute rules. Everything is subject to negotiation.

Because of the level of effort required, you will probably only allow one buyer at a time to conduct an intensive program of due diligence. Many buyers insist on limited exclusivity prior to embarking upon detailed due diligence. The key, from the seller's perspective, is to ensure that the program does not become bogged down. Remember that the goal is to reach an accord with that buyer, or to move along to the next one. Care should be taken to ensure that independent professionals do not get carried away with their analyses. The buyer's professionals have a self-serving incentive to bring up problems in order to negotiate a lower purchase price and to protect themselves from liability for errors and omissions. As a consequence, you should make sure that you stay in close contact with the buyer, and that his or her professionals do not become deal killers.

You must also sometimes remind the buyer that:

- He or she will never learn everything about the business;
- Any business, when viewed under a microscope, has blemishes; and
- No amount of due diligence can totally eliminate risk.

While the buyer is doing due diligence on your company, it's hardly out of line to be conducting due diligence on the buyer. First of all, you have to satisfy yourself that the buyer has the financial capacity and strategic incentive to buy your company. It is appropriate to ask the buyer for financial statements, query the buyer's motives thoroughly and, as discussions progress, to tour the facilities and interview the senior management. The result of many M&A transactions is that the apparent seller develops a financial interest in the buyer, either because the transaction is a merger and both parties have a financial interest in each other as a result of a stock swap, or because the buyer will pay some of the purchase price through future consideration. You need to be satisfied that the buyer will be capable of meeting these prospective obligations. Also, you don't want to deliver your company into the hands of a buyer who will run it into the ground.

ALTERNATIVES TO SELLING THE COMPANY

There are many ways that you can achieve many of the benefits of selling your company without actually relinquishing control. One approach is to refinance the business, by leveraging it up and using the loan proceeds to retire stock. It is quite possible that this is effectively what the buyer will be doing with your company to cash you out. By refinancing, you cash out the surplus equity, and still own the company. The ability to do this depends upon the company. If you must personally guarantee the debt, then many of the benefits of refinancing may be lost if the company falters.

Selling off surplus assets, sale/leaseback transactions, or divestitures of product lines, subsidiaries, or divisions constitute another method of raising cash while still preserving a core business.

Companies deficient in management, marketing, manufacturing, capital, or other key ingredients, may mitigate deficiencies by engaging in a joint venture, or selling a minority interest in the business. In recent years Employee Stock Ownership Plans have provided tax-favored methods of providing capital for owners, without selling control to outsiders. You should evaluate your alternatives before deciding that a sale is the only means of achieving your objective.

* * * * *

We are now at the stage where things really begin to heat up. We have discussed from both the buyer's and the seller's perspective how deals originate; the role of intermediaries; how to identify a buyer or seller; establishing the initial contact; the due diligence process; and alternatives to buying and selling.

EXHIBIT 3-1
KEY ELEMENTS OF AN AGREEMENT WITH AN INVESTMENT INTERMEDIARY

- Description of services to be rendered
- Exclusivity of relationship
- Duration of agreement
  - Active phase of assistance
  - What if the transaction breaks down, but is subsequently completed?
- Termination clauses
- Basis for compensation
  - Noncontingent
  - Contingent
- Nature of reimbursable expenses
- Definition of a successful transaction
  - Sale of the company?
  - Bona fide offer for target sale price?
  - Intermediary merely makes an introduction? Introduces party who introduces buyer?
- Success fee
  - Lehman formula
  - Percent of total transaction value
  - Fixed amount
  - Premium over normal billing rate
  - Percent of proceeds in excess of a certain amount
- Basis for calculating transaction value in computing success fee
  - Purchase price of common stock only? Plus preferred stock? Bank debt? Capitalized obligations? Other liabilities? Contingent payments? Seller notes? Consulting contracts with seller?
- Impact on fees if more than one intermediary must be paid
- Timing of fee payments
- Indemnification of intermediary against liability resulting from actions undertaken on behalf of the seller

EXHIBIT 3-2
XYZ CORP.
PRO FORMA OPERATING CASH FLOW
FOR THE YEAR ENDED DECEMBER 31, 19X1

	Actual	Adjustments	Pro Forma
Net sales:			
Actual	$22,600		22,600
Annual effect of new NYA contract		880	880
Repricing of ABC contract		250	250
Additional sales from new LA office		1,750	1,750
Elimination of DAZ product line		(1,100)	(1,100)
	22,600	1,780	24,380
Cost of goods sold:			
Actual	14,916		14,916
Annual effect of new NYA contract		484	484
Additional sales from new LA office		963	963
Elimination of DAZ product line		(1,210)	(1,210)
Cost savings from GGG equipment		(350)	(350)
Cost savings from new scheduling system		(400)	(400)
Nonrecurring cost of mechanical breakdown		(200)	(200)
Energy reduction program		(125)	(125)
	14,916	(838)	14,078
Gross profit	7,684	2,618	10,302
Selling, general and administrative expenses			
Actual	4,972		4,972
Additional costs of LA office		340	340
Excess owners' compensation		(250)	(250)
Owner's perquisites		(170)	(170)
Nonworking family members on payroll		(70)	(70)
Nonrecurring professional fees		(225)	(225)
	4,972	(375)	4,597
Operating cash flow	$2,712	2,993	5,705

EXHIBIT 3-3
XYZ CORP.
PRO FORMA BALANCE SHEET
FOR THE YEAR ENDED DECEMBER 31, 19X1

	Actual	Adjustments	Pro Forma	Explanation of Adjustment
ASSETS				
Cash	$ 600		600	
Accounts receivable	3,800		3,800	
Inventory	4,000	680	4,680	LIFO adjustment
Other current assets	325		325	
Net fixed assets	4,250	2,250	6,500	Reflects appraised value
Other	1,350	150	1,500	Value of patents
	$14,325	3,080	17,405	
LIABILITIES				
Current liabilities	$4,500		4,500	
Funded debt	3,200	(300)	2,900	Below-market interest rate on debt
	7,700	(300)	7,400	
NET WORTH	6,625	3,380	10,005	
	$14,325	3,080	17,405	

EXHIBIT 3-4
EXAMPLE OF BUYER EVALUATION CRITERIA

Buyer Evaluation Criteria	**Weight**
1. Reputation of buyer	*25%*
2. Expertise in widget industry	*10%*
3. Marketing and sales benefits	*10%*
4. Financial strength	*25%*
5. Compatibility of buyer with employees	*5%*
6. Track record in closing deals	*5%*
7. Strength of apparent motive to acquire Seller	*15%*
8. Intangible or subjective rating	*5%*
TOTAL	*100%*

Instructions: Assign a percentage rating based on its relative importance in determining the best buyer. The total of the individual percentages assigned to each criterion should equal 100%.

EXHIBIT 3-5
EXAMPLE OF BUYER GRADING FORM

BUYER GRADING CRITERIA	WEIGHT	BUYER A	BUYER B	BUYER C	BUYER D	BUYER E
1. Reputation of buyer	25%	2	1	4	0	2
2. Expertise in widget industry	10%	2	1	0	2	4
3. Marketing and sales benefits	10%	2	2	0	1	1
4. Financial strength	25%	1	2	4	2	0
5. Compatibility of buyer with employees	5%	1	1	1	0	4
6. Track record in closing deals	5%	1	-2	4	0	0
7. Strength of apparent motive to acquire Seller	15%	1	2	1	1	2
8. Intangible or subjective rating	5%	1	2	4	1	2
WEIGHTED TOTAL	100%	1.45	1.40	2.60	1.00	1.60
RANKING		3	4	1	5	2

4 = Clearly superior; 2 = Good; 1 = Adequate; 0 = No basis for grade; -2 = Unacceptable

CHAPTER 4
PRICING THE TRANSACTION

INTRODUCTION

There are three principal factors that impact the success of a merger or acquisition:

- The price you pay;
- How well you run the company; and
- The price at which you sell.

Two of the three principal factors depend upon valuation. In this section we discuss various valuation methods which can be used to establish the price of a buyout candidate.

To start with, bear in mind that an asset is worth only as much as somebody is willing to pay for it. The standard definition of fair market value is the price at which property would change hands between a willing and knowledgeable buyer and seller. In chapters 2 and 3 we discussed how we bring the buyer and seller together. The valuation process is the means by which we document value. It doesn't ensure that you will realize that value in a transaction. That depends upon bringing the right buyers to the negotiating table, and the respective negotiating skills of the parties to the transaction. The valuation methods constitute a starting point for establishing price expectations.

Valuations can generally be characterized as falling into one of seven general categories:

- Industry "rules of thumb;"
- Asset-based valuation methods;
- Capitalization methods;
- Comparable company methods;
- Comparable acquisition methods;
- Discounted cash flow analysis; and
- Leveraged buyout methods

Each method has its own specific advantages and applications. More important than the valuation method is the ability and experience of the individual performing the valuation. The correct valuation method, improperly applied, can provide a misleading indication of value.

Valuations build upon the type of information normally contained in an information memorandum, as well as that which would normally be developed during due diligence. The oft-cited Revenue Ruling 59-60 refers to eight fundamental factors in valuing companies:

1) The nature of the business including its history since organization;

2) The economic status of the industry and the nation at the critical date of valuation;

3) Asset value;

4) Earnings;

5) Dividends and dividend-paying capacity;

6) The existence or lack of intangible value;

7) Sales of the stock and the size of the block to be valued; and

8) The selling price of comparable securities relative to their earnings, dividends and asset values.

These and other factors are used to compute value.

RULES OF THUMB

A starting point for estimating value is often "rules of thumb." Rules of thumb are neither scientific nor precise. However, they are benchmarks that may be familiar to people in a particular industry. For example, most recently, cable television franchises have tended to sell at about $2,000 per subscriber. To apply this rule of thumb to an individual franchise, you would tally the number of subscribers, and multiply that number by $2,000. For example, if a franchise had 1,000 subscribers, based on the rule of thumb, it would be worth $2 million.

Obviously, some franchises are worth more than others. Factors such as profitability, prospective growth rates, market saturation, and additional services would have a major impact upon which side of $2,000 per subscriber the transaction would be consummated. But be aware of the rules of thumb applicable to a particular industry. You may have to persuade a buyer or seller why a company is worth more or less than the common benchmark.

ASSET-BASED VALUATION METHODS

Asset-based methods constitute a family of valuation methods that are perhaps the easiest to visualize. The standard asset-based valuation methods are based on book value, tangible book value, appraised value, "excess earnings," liquidation value, and startup costs. They all are based on the notion that value is the net difference between assets and liabilities. They generally do not directly reflect the earnings capability of the company. You will find it helpful to refer to Chapter 4 to review the examples of each valuation method, as applied to a single company that we shall refer to as "Target Company." The asset-based valuation methods are shown in Exhibit 4-2.

The book value method is the most fundamental of asset-based valuation method. It merely reflects the net difference of assets, at their adjusted historical costs, less liabilities. Many transactions involving small companies are based on book value. However, book value does not provide a true indication of the value of a company's assets or its earnings capacity.

Tangible book value reflects the net difference between tangible assets, at their adjusted historical cost, and liabilities. It is identical to the book value method, except that intangible assets such as goodwill and capitalized intangible costs are excluded. If you are negotiating with an unsophisticated seller who insists on selling his or her company for book value, to reduce the price you might insist on removing intangible assets. After all, by their very nature, they are generally not severable assets which can be sold separately.

Appraised value reflects the net difference between the appraised value of assets and liabilities. This method is a common reference point for many transactions. There is something intuitively comfortable about purchasing a company for the appraised value of its assets and liabilities, particularly if the transaction is structured as an asset sale. Appraised value is important for accounting and tax purposes, since many of these values will be used in computing the basis of the transaction. Nevertheless, a business is more than a collection of assets and liabilities. How many of us would sell a professional practice such as an accounting firm or a medical practice for the value of accounts receivable, supplies, and office equipment?

The "excess earnings" method of valuation starts with the appraised value of assets less liabilities. A premium or discount is applied to that net balance to reflect the net difference between the earnings capacity of Target Company and its net asset value. For example, if a company had a net appraised value of $1 million, and we regarded 15% to be a normal rate of return on assets, then we would expect to earn $150,000 per year on the investment. If the company were earning $200,000 per year, we would say that it had "excess earnings" of $50,000 per year. These "excess earnings" would be capitalized at 15%. In the computation, $50,000 would be divided by 15%, resulting in a capitalized value of $333,333. The capitalized "excess earnings" would be added to the appraised value of the company to compute its value based on excess earnings. That value would be $1,333,333 in the example just cited.

Liquidation value reflects the liquidation value of assets, less the cost of liquidation and the liabilities that would have to be satisfied. It is often used by lenders and investors as a measure of the potential downside of an investment.

Startup cost reflects the cost of creating a business similar to Target Company. The calculation reflects the cost of replicating the assets of Target Company, less its liabilities, and further reduced for losses and other costs which would be incurred until you would have a company of similar scope and profitability to Target Company. The resulting number tells us whether it is less expensive to "make or buy." You shouldn't generally offer to pay more for a business than the cost of building a similar one.

CAPITALIZATION METHODS

Capitalization methods establish value by "capitalizing" or multiplying a financial result by a given multiple. If we say that a company is worth ten times earnings, we are capitalizing its annual earnings by a multiple of ten. If annual earnings are $1 million, the company is worth $10 million. Examples of several valuations based on capitalization multiples are provided in Exhibit 4-3.

The financial results that are normally capitalized include earnings, pretax earnings, operating income, operating cash flow, net cash flow, and revenues. Historical numbers are generally used. They may reflect a single year, or an average reflecting several years. Projected numbers are also sometimes used.

Capitalization multiples are often nothing more than rules of thumb, or screening guidelines used by active buyers to quickly screen large numbers of deals. For example, accounting firms and certain other professional service firms frequently sell for a multiple of one times revenues, plus or minus an amount based on the unique attributes of the firm. Leveraged buyout firms often screen deals by ferreting out those deals priced in excess of 6 times cash flow. A buyout multiple of 6 times cash flow produces an annual yield of 16.7% based on historical cash flow, which should be sufficient to service debt, assuming that debt costs less than 16.7% per year.

Capitalization methods have an advantage over asset-based methods, in that they generally relate in some fashion to the earnings capacity of the company. The multiples, however, may be quite subjective. How do you decide whether a company is worth 8 times earnings versus 10 times earnings? A 10-times multiple of earnings results in a value that is 25% greater than 8 times earnings.

COMPARABLE COMPANY METHODS

Comparable company methods of valuation eliminate much of the subjectivity of the capitalization methods. Rather than arbitrarily selecting a capitalization multiple, comparable company valuations use capitalization multiples of so-called "comparable" publicly held companies. The capitalization multiples of truly comparable companies provide independent benchmarks for estimating value.

These multiples are based on stock prices resulting from numerous independent transactions between buyers and sellers in the public markets.

To apply the comparable company method, we must select a group of publicly traded companies which has similar investment characteristics to Target Company. To be a comparable company, they do not have to be identical in every respect to Target Company. This would be impossible. The comparable companies simply need to, as a group, reflect investment characteristics which are relevant to the value of Target Company. Whether the comparable companies are larger or smaller than Target Company should not be an overriding factor. The earnings capitalization multiples, for example, divide the total value of each comparable company by its total earnings. If the comparable company has a billion dollars in value and $100 million in earnings, or $10 million in value and $1 million in earnings, its earnings capitalization multiple is 10. For valuation purposes, the capitalization multiples are important, rather than the gross dollars used to calculate the multiples.

Normally, in a comparable company valuation, you will develop several capitalization multiples for each comparable company. The capitalization multiples may include multiples of earnings, revenues, book value, and several other financial attributes. To value Target Company, you will apply a single multiple of earnings, book value, revenues, and other financial attributes to the earnings, book value, revenues, and other financial attributes, respectively, of Target Company. The multiples which you employ will be based on the multiples of the comparable companies. If you use three multiples, say, multiples of earnings, book value, and revenues, you will have three values for Target Company. To arrive at a single value for Target Company, you weight each value. For example, by giving a 1/3 weight to the value computed by applying each capitalization multiple, you will arrive at a single value for Target Company.

Invariably, the comparable companies as a group will vary in some material respects from Target Company. Premiums or discounts may be applied to consider factors such as controlling interests, illiquidity, dependence upon a key customer or executive, or other differentiating factors. Adjustments may need to be made to the financial results of Target Company or the comparable companies to eliminate the impact of nonrecurring items or other factors which could distort value. The comparable company method may be applied based on the market value of the common stock of the comparable companies, or based on their total invested capital, including funded debt. Both methods are shown in Exhibit 4-4 and 4-5.

COMPARABLE ACQUISITIONS METHODS

The comparable company method is commonly used to value public and privately held companies. A limitation of the comparable company method is that it is based on capitalization multiples derived from prices on trades of minority interests in the comparable companies. In an acquisition you are buying a controlling interest in the acquisition candidate. The value of a controlling interest is often different than the aggregate value of minority interests. Developing value based on the capitalization multiples paid in acquisitions of companies with investment characteristics resembling those of Target Company provides another useful check on value. The comparable acquisitions method is applied in an identical fashion to the comparable company method. Acquisition multiples of earnings, book value, revenues, and other relevant financial attributes are applied to the pertinent financial attributes of Target Company. The resultant values are weighted and adjusted for any appropriate premiums or discounts. Examples are shown in Exhibits 4-6 and 4-7.

Although the comparable acquisitions method would seem to be the most relevant method for valuing an acquisition candidate, its usefulness is limited by the number of relevant acquisitions about which reliable data is available. Since the preponderance of acquisitions is of privately held companies, it can be difficult to obtain detailed information about them. There are about 15,000 publicly held companies about which current information can be obtained. There are less than 1,000 acquisitions per year about which reliable data is available.

DISCOUNTED CASH FLOW ANALYSIS

All of the valuation methods that we have discussed so far are based on historical data. They reflect historical earnings, book value, and other financial results. The success of an investment and the ability to repay debt depend upon future results. Discounted cash flow analysis provides a method of developing value based on prospective financial performance. Its essential premise is that the value of a company is the value in today's dollars of all future cash flows that you project from the investment. To estimate the value today of future cash flows, you discount them to a present value, based on the interest rate appropriate for capital employed. The sum of these "discounted" future cash flows is the value of Target Company, based on discounted cash flow analysis.

In performing a discounted cash flow analysis, there are three main ingredients: the cash flow projections; the discount rate; and the terminal value. A detailed set of cash flow projections for Target Company is contained in Exhibit 4-10. The discount rate is based on the after tax cost of capital employed. In recent years, the interest rate on debt to most borrowers has ranged between 10% and 16%. Due to the tax deductions from employing debt, the after tax cost of debt is normally less than its pretax rate of interest. For example, a taxpayer in the 40% tax bracket has an after tax cost of 7.2% on debt bearing an interest rate of 12%. The effective cost of equity capital is equal to the required return on equity capital. On most investments this cost exceeds 15%, often by a considerable margin, depending on risk. The terminal value or residual value of the company is its value at the end of the cash flow projection period. This represents the potential cash flow that could be realized by selling the company at the end of the period projected. The sum of the discounted value of the annual cash flows and the discounted value of the terminal value equals the value of the company.

Discounted cash flow analysis can be performed by discounting —that is, cash flow before debt service and taxes—at the weighted average cost of capital which reflects both debt and equity, or it can be performed by discounting the net cash flow available to shareholders at the higher discount rate for equity only, and adding to that amount the amount of acquisition debt that will be employed. Both approaches to discounted cash flow analysis are shown in Exhibit 4-8.

Clearly the quality of discounted cash flow analysis is dependent upon the quality of your projections and the reasonableness of the discount rate employed. As is the case with any valuation method, garbage in results in garbage out.

LEVERAGED BUYOUT METHODS

Leveraged buyout methods predicate value on the amount of funding available for the proposed transaction. Funding is typically comprised of secured debt, unsecured loans, and equity. Secured debt can include asset-based loans on receivables, inventory, and other hard assets, as well as mortgages on real estate. In larger deals unsecured loans or subordinated term loans may be available from commercial lenders or through the high-yield bond markets. Unsecured debt and subordinated debt on middle-market transactions may consist of notes due to the seller. Common stock, preferred stock, and a variety of other creative financial instruments comprise the other forms of consideration used in leveraged buyout transactions. The price paid under the leveraged buyout method is the sum of available funding from the various funding sources, including the seller. An example is shown on Exhibit 4-9.

To apply the leveraged buyout method, it is important to be familiar with the lending criteria used in the capital markets. Chapter 7 provides a discussion of various forms of financing that are available. Constraints on purchase price may be externally imposed by the capital markets, or they may be the result of a conscious decision by the buyer. The example shown in Exhibit 4-9 indicates that the target company can support an asset-based loan of $8,305. However, by drawing the credit line to the limit, the buyer would be unable to borrow additional funds to use in operations. Accordingly, the buyer may use less than the full amount of the available credit line to fund the acquisition, and thereby limit the price offered to the seller. At the same time, even if return on investment calculations and other valuation analyses support a $3,000 equity value in the same example, the buyer may only be willing to commit $2,000 in equity to the transaction, in which case, the offering price would be reduced by $1,000.

The leveraged buyout method directly addresses transaction funding, rather than transaction value. Since funding is usually dependent upon asset values and cash flows, it is a good way of checking the reasonableness of other methods of valuation.

APPLYING THE RESULTS

Mark Twain once said that man is the only creature to have found the perfect religion—many of them. The same can be said for valuation methods. There are innumerable methods of valuation. Practitioners do not universally apply each method of valuation in a uniform manner. More than a single method of valuation can be relevant to a particular situation. It can be useful to employ several valuation methods to value an acquisition candidate, in order to see if a consensus of value emerges. This is useful, both to confirm your assessment as to value, and to appreciate the position that the party on the other side of the negotiating table may have. Exhibit 4-1 summarizes the results of each of the valuation methods that we have just used to value Target Company.

Valuation analyses can be used as tools to support buyout negotiations. If properly prepared, valuations provide an objective basis for documenting value. If a buyer or seller has unrealistic price objectives, the valuation analyses can be used to provide a dispassionate view as to the value of the company. Even if the buyer or seller adopts a rigid view, if he is represented by capable professionals, they should be able to advise him privately whether your valuation has a reasonable foundation. If the other party remains recalcitrant, you should be prepared to walk away from the deal, offer to come back at a later date, or seek to modify the payout terms.

A valuation report or fairness opinion is often a valuable tool for securing bank financing or supporting the decision of the board of directors to approve a transaction. Lenders financing a buyout transaction want to be confident that the company is worth no more or no less than the price that is paid. It better be worth the price that is paid, because the company and its assets probably constitute the collateral for their loan. They don't want to start out behind the eightball by having collateral that is worth less than the purchase price. On the other hand, recent concern about an old legal principal known as a fraudulent conveyance, where assets are sold for less than their fair value to the detriment of creditors, has caused bankers and buyers to also be concerned that a transaction cannot later be reversed or litigation be initiated because of an unreasonably low purchase price. Exhibit 4-10 contains a summary of the key elements of a properly documented valuation report or fairness opinion.

* * * * *

A fundamental tenet of business is to "buy low/sell high." If you don't understand the basics of business valuation, you don't know if you are buying or selling high or low. We have discussed the major categories of valuation methods—specifically:

- Rules of thumb;
- Asset-based methods;
- Capitalization methods;
- Comparable company methods;
- Comparable acquisitions methods; and
- Discounted cash flow analysis.

These are important tools. Don't leave home, or call yourself an M&A pro without them.

EXHIBIT 4-1
XYZ CORP.
EXAMPLES OF SELECTED VALUATION METHODS

Valuation Method	Value	Reference
Asset-Based Valuation Methods:		
Net book value	$6,625	Exhibit 4-2
Net appraised value	8,215	Exhibit 4-2
"Excess earnings"	11,127	Exhibit 4-2
Net liquidation value	2,295	Exhibit 4-2
Net startup cost	11,735	Exhibit 4-2
Capitalization Methods:		
Revenues	11,300	Exhibit 4-3
Net income capitalization	11,683	Exhibit 4-3
Pretax income capitalization	11,683	Exhibit 4-3
Operating income capitalization	11,619	Exhibit 4-3
Operating cash flow capitalization	13,072	Exhibit 4-3
Book value	9,938	Exhibit 4-3
Comparable Company Methods:		
Based on equity values	10,963	Exhibit 4-4
Based on total invested capital	10,252	Exhibit 4-5
Comparable Acquisitions Method:		
Based on equity values	14,231	Exhibit 4-6
Based on total invested capital	14,254	Exhibit 4-7
Discounted Cash Flow Analysis:		
Capitalization of firm cash flow	15,562 to 17,418	Exhibit 4-8
Capitalization of cash flow available to investors	12,273 to 13,397	Exhibit 4-8
Leveraged Buyout Method	10,605	Exhibit 4-9
Historical and Projected Cash Flow		Exhibit 4-10

EXHIBIT 4-2
XYZ CORP.
EXAMPLES OF ASSET-BASED VALUATION METHODS
DECEMBER 31, 19X1

	Book Value	Tangible Book Value	Appraised Value	"Excess Earnings"	Liquidation Value	Startup Cost
Cash	$600	600	600	600	600	600
Accounts receivable	3,800	3,800	3,600	3,600	2,850	3,800
Inventory	4,000	4,000	3,800	3,800	1,600	4,000
Other current assets	325	325	315	315	81	325
Net fixed assets	4,250	4,250	6,500	6,500	4,875	7,000
Goodwill	400	0	0	0	0	0
Other assets	950	950	1,100	1,100	380	1,210
Current liabilities	(4,500)	(4,500)	(4,500)	(4,500)	(4,500)	(4,500)
Funded debt	(3,200)	(3,200)	(3,200)	(3,200)	(3,200)	(3,200)
Capitalized "excess earnings"	0	0	0	2,912	0	0
Liquidation costs	0	0	0	0	(391)	0
Losses during startup phase	0	0	0	0	0	2,500
	$6,625	6,225	8,215	11,127	2,295	11,735

EXHIBIT 4-3
XYZ CORP.
EXAMPLES OF CAPITALIZATION METHODS
DECEMBER 31, 19X1

Capitalization Method	Amount to be Capitalized	Capital-ization Factor	Gross Capitalized Value	Long-term Debt	Net Capitalized Value
CAPITALIZED REVENUES					
Revenues	22,600	50.0%	$11,300		
CAPITALIZED EARNINGS					
Net income	$1,168	10.0	$11,683		
CAPITALIZED PRETAX EARNINGS					
Pretax earnings	$1,669	7.0	$11,683		
CAPITALIZED OPERATING INCOME					
Operating income	$2,117	7.0	$14,819	(3,200)	$11,619
CAPITALIZED OPERATING CASH FLOW					
Operating cash flow	$2,712	6.0	$16,272	(3,200)	$13,072
CAPITALIZED BOOK VALUE					
Book value	6,625	1.5	$9,938		

EXHIBIT 4-4
XYZ CORP.
EXAMPLE OF COMPARABLE COMPANY METHOD
BASED ON STOCK PRICE CAPITALIZATION
DECEMBER 31, 19X1

	Price/ Earnings	Price/ Weighted Average Earnings	Price/ Revenues	Price/ Book Value	Total
Multiples:					
Comparable company #1	8.1	10.1	0.45	1.56	
Comparable company #2	9.5	11.2	0.52	1.41	
Comparable company #3	7.8	9.5	0.39	1.25	
Comparable company #4	11.2	10.9	0.61	1.83	
Comparable company #5	10.4	13.5	0.68	2.02	
Comparable company #6	9.1	10.3	0.46	1.64	
Average	9.4	10.9	0.52	1.62	
	x	x	x	x	
XYZ Corp. financial results	$1,168	994	22,600	6,625	
Components of value	$10,924	10,851	11,714	10,721	
	x	x	x	x	
Weighting	30%	25%	15%	30%	100%
Weighted value	$3,277	2,713	1,757	3,216	$10,963

EXHIBIT 4-5
XYZ CORP.
EXAMPLE OF COMPARABLE COMPANY METHOD
BASED ON TOTAL INVESTED CAPITAL (TIC)
DECEMBER 31, 19X1

	TIC/ Operating Cash Flow	TIC/ Operating Income	TIC/ Wtd. Ave. Operating Cash Flow	TIC/ Wtd. Ave. Operating Income	TIC/ Revenues	TIC/ Net Operating Assets	Total
Multiples:							
Comparable company #1	4.3	5.7	5.4	7.2	0.56	1.37	
Comparable company #2	5.2	6.5	6.3	7.8	0.65	1.29	
Comparable company #3	3.9	4.4	4.9	5.3	0.49	1.15	
Comparable company #4	6.5	7.6	5.9	7.0	0.76	1.58	
Comparable company #5	5.8	6.9	7.4	8.8	0.85	1.84	
Comparable company #6	4.9	6.1	5.7	6.8	0.58	1.39	
Average	5.1	6.2	5.9	7.2	0.65	1.44	
	x	x	x	x	x	x	
XYZ Corp. financial results	$2,712	2,117	2,377	1,783	22,600	8,825	
Components of value	$13,831	13,125	14,106	12,753	14,643	12,679	
	x	x	x	x	x	x	
Weighting	25%	15%	15%	10%	10%	25%	100%
Weighted value	$3,458	1,969	2,116	1,275	1,464	3,170	$13,452
Funded debt							(3,200)
Value of common equity							$10,252

EXHIBIT 4-6
XYZ CORP.
EXAMPLE OF COMPARABLE ACQUISITIONS METHOD
BASED ON PURCHASE PRICE OF COMMON STOCK
DECEMBER 31, 19X1

	Price/ Earnings	Price/ Weighted Average Earnings	Price/ Revenues	Price/ Book Value	Total
Multiples:					
Comparable acquisition #1	12.8	15.1	0.70	1.90	
Comparable acquisition #2	10.9	13.3	0.55	1.75	
Comparable acquisition #3	13.4	13.1	0.73	2.20	
Comparable acquisition #4	13.5	17.6	0.88	2.63	
Comparable acquisition #5	10.5	11.8	0.53	1.89	
Average	12.2	14.2	0.68	2.07	
	x	x	x	x	
XYZ Corp. financial results	$1,168	994	22,600	6,625	
Components of value	$14,293	14,094	15,336	13,729	
	x	x	x	x	
Weighting	30%	25%	15%	30%	100%
Weighted value	$4,288	3,523	2,300	4,119	$14,231

EXHIBIT 4-7
XYZ CORP.
EXAMPLE OF COMPARABLE ACQUISITIONS METHOD
BASED ON TOTAL INVESTED CAPITAL (TIC)
DECEMBER 31, 19X1

	TIC/ Operating Cash Flow	TIC/ Operating Income	TIC/ Wtd. Ave. Operating Cash Flow	TIC/ Wtd. Ave. Operating Income	TIC/ Revenues	TIC/ Net Operating Assets	Total
Multiples:							
Comparable acquisition #1	7.0	8.8	8.5	10.6	0.88	1.74	
Comparable acquisition #2	5.5	6.2	6.8	7.4	0.68	1.61	
Comparable acquisition #3	7.8	9.1	7.1	8.4	0.92	1.90	
Comparable acquisition #4	7.5	9.0	9.6	11.4	1.11	2.39	
Comparable acquisition #5	5.6	7.0	6.6	7.9	0.66	1.60	
Average	6.7	8.0	7.7	9.1	0.85	1.85	
	x	x	x	x	x	x	
XYZ Corp.	$2,712	2,117	2,377	1,783	22,600	8,825	
Components of value	$18,146	16,953	18,355	16,281	19,170	16,305	
	x	x	x	x	x	x	
Weighting	25%	15%	15%	10%	10%	25%	100%
Weighted value	$4,536	2,543	2,753	1,628	1,917	4,076	$17,454
Funded debt							(3,200)
Value of common equity							$14,254

EXHIBIT 4-8
XYZ CORP.
EXAMPLES OF DISCOUNTED CASH FLOW ANALYSIS
BASED ON PROJECTIONS FOR THE SEVEN YEARS ENDED DECEMBER 31, 19X8

	19X2	19X3	19X4	19X5	19X6	19X7	19X8	Total	Acq. Debt	Debt O/S 12/31/X1	Equity
CAPITALIZATION OF FIRM CASH FLOW											
FCF from operations	$1,994	2,087	2,184	2,286	2,392	2,503	2,619				
Terminal value							22,896				
	1,994	2,087	2,184	2,286	2,392	2,503	25,515				
Present value at weighted average cost of aggregate capital of:											
12%	1,780	1,664	1,555	1,453	1,357	1,268	11,542	20,618	NA	(3,200)	$17,418
13%	1,764	1,634	1,514	1,402	1,298	1,202	10,846	19,660	NA	(3,200)	$16,460
14%	1,749	1,606	1,474	1,353	1,242	1,140	10,197	18,762	NA	(3,200)	$15,562
CAPITALIZATION OF CASH FLOW AVAILABLE TO SHAREHOLDERS											
Free cash flow	56	150	(232)	(89)	(184)	(14)	(81)				
Terminal value							22,896				
Funded debt							(5,250)				
	56	150	(232)	(89)	(184)	(14)	17,565				
Present value of FCF at required return on equity capital of:											
18%	47	108	(141)	(46)	(80)	(5)	5,514	5,397	8,000	NA	$13,397
20%	47	104	(134)	(43)	(74)	(5)	4,902	4,798	8,000	NA	$12,798
22%	46	101	(127)	(40)	(68)	(4)	4,367	4,273	8,000	NA	$12,273

EXHIBIT 4-9
XYZ CORP.
EXAMPLE OF LEVERAGED BUYOUT METHOD
BASED ON FINANCIAL CONDITION AS OF DECEMBER 31, 19X1

Description	Appraised Value	Advance Rate	Component of Value
Asset-based financing:			
Cash	$600	100.0%	$600
Accounts receivable	3,600	80.0%	2,880
Inventory	3,800	50.0%	1,900
Other current assets	315	0.0%	0
Fixed assets (liquidation value)	4,875	60.0%	2,925
Other assets	1,100	0.0%	0
			8,305
Term loan			2,500
Equity financing			3,000
			13,805
Less: funded debt at 12/31/X1			(3,200)
			$10,605

EXHIBIT 4-10
XYZ CORP.
HISTORICAL AND PROJECTED CASH FLOW
FOR THE EIGHT YEARS ENDED DECEMBER 31, 19X8

	19X1	19X2P	19X3P	19X4P	19X5P	19X6P	19X7P	19X8P
Net sales	$22,600	23,730	24,917	26,162	27,470	28,844	30,286	31,800
Cost of goods sold	(14,916)	(15,662)	(16,445)	(17,267)	(18,130)	(19,037)	(19,989)	(20,988)
Gross profit	7,684	8,068	8,472	8,895	9,340	9,807	10,297	10,812
General and admin. expenses	(2,938)	(3,085)	(3,239)	(3,401)	(3,571)	(3,750)	(3,937)	(4,134)
Selling expenses	(2,034)	(2,136)	(2,242)	(2,355)	(2,472)	(2,596)	(2,726)	(2,862)
Operating cash flow	2,712	2,848	2,990	3,139	3,296	3,461	3,634	3,816
Depreciation and amortization	(595)	(642)	(691)	(742)	(796)	(853)	(913)	(976)
Operating income	2,117	2,206	2,299	2,397	2,500	2,608	2,722	2,841
Interest expense	(448)	(1,323)	(1,281)	(1,209)	(1,107)	(990)	(858)	(711)
Income before taxes	1,669	883	1,018	1,188	1,393	1,618	1,864	2,130
Income taxes	(501)	(265)	(305)	(356)	(418)	(485)	(559)	(639)
Net income	1,168	618	713	832	975	1,133	1,305	1,491
Add:								
Interest and income taxes paid	949	1,588	1,586	1,565	1,525	1,475	1,417	1,350
Depreciation and amortization	595	642	691	742	796	853	913	976
Operating cash flow	2,712	2,848	2,990	3,139	3,296	3,461	3,634	3,816
Less:								
Increase in working capital	(170)	(178)	(187)	(196)	(206)	(216)	(227)	(239)
Capital expenditures	(638)	(676)	(716)	(759)	(805)	(853)	(904)	(959)
Free cash flow from operations	1,905	1,994	2,087	2,184	2,286	2,392	2,503	2,619
Interest and income taxes paid	(949)	(1,588)	(1,586)	(1,565)	(1,525)	(1,475)	(1,417)	(1,350)
Net repayment of debt	(350)	(350)	(350)	(850)	(850)	(1,100)	(1,100)	(1,350)
Free cash flow	$606	$56	$150	($232)	($89)	($184)	($14)	($81)
Indebtedness at December 31:								
Incurred prior to acquisition	3,200	2,850	2,500	2,150	1,800	1,450	1,100	750
Acquisition & new debt	0	8,000	8,000	7,500	7,000	6,250	5,500	4,500

EXHIBIT 4-11
ELEMENTS OF A VALUATION REPORT

- Type of report
- Description of asset to be valued
- Purpose of valuation
- Use of report
- Valuation date
- Description of valuation methodology (ies)
- Reasons for using methodology (ies) selected
- Reasons for not using other methodologies
- Estimate of value
- Corroborative indications of value
- Qualifications to report
- Statement regarding independence
- Qualifications of valuation expert
- Signature

CHAPTER 5
STRUCTURING THE TRANSACTION

INTRODUCTION

In this section, we cover structuring a business combination. These main structuring alternatives available sets the stage for the accounting and tax discussion Chapter 6. Although the alternatives from the vantage point of the buyer is described, each of these considerations is important to both buyers and sellers.

As you enter structuring negotiations, the stated dollar range of the purchase price may be fairly well established. It may have been agreed to at an earlier stage of negotiations. A major objective of structuring a transaction is to create a transaction that appears to meet the seller's price expectations, on terms and within constraints that are suitable to the buyer. You are bound solely by the law, the tax code, and your imagination. As one notable buyer frequently instructed his lieutenants: "the other guy's price, but my toims."

There are two major types of transactions: mergers and acquisitions. Often the two terms are interchangeably used by laymen. In a merger, both parties to the transaction wind up with common stock in a single merged entity. In an acquisition, the acquirer buys the common stock or assets of the seller. From a legal perspective, a merger is more akin to a marriage, whereas in an acquisition, the buyer becomes the owner of the seller's business. The vast majority of all transactions are acquisitions rather than mergers.

MERGERS

Despite the legal characterization of mergers as marriages, they are seldom marriages of equals. Often, they are marriages of convenience. "Merger" may mean the acquisition was financed through the use of common stock rather than by other means. You may hear mention of forward mergers, reverse mergers, subsidiary mergers, and triangular mergers. In a forward merger, the target merges into the buyer company, and its shareholders receive the buyer's stock. In a reverse merger, the buyer is absorbed into the target, and receives the target's stock. A subsidiary merger is executed when a buyer incorporates an acquisition subsidiary which merges with the target. In a triangular merger, the target's assets are conveyed to the buyer's company in exchange for the buyer's stock. Each structure can have different tax and legal consequences.

The main reasons why a buyer and seller may agree to a merger as a method of effectuating a buyout are:

- A merger does not require cash;
- A merger can be executed on a tax-free basis, thereby allowing the seller to defer paying capital gains taxes;
- A merger allows the seller to benefit from the appreciation potential of the securities of the merged entity, rather than limiting proceeds to the consideration paid on the date of the transaction;
- The historical financial statements of the merged entities are recast to show them as a single entity, which may make them appear to be financially stronger;
- If the value of a closely held target is significant relative to that of a widely held buyer, the shareholders of the target may view the merger as a way of becoming the major shareholders of a larger merged entity;
- A merger of a privately held company into a publicly held company allows the target shareholders to receive liquid stock, constrained only by SEC Rule 144 which places some limitations on subsequent resale;
- A merger allows the buyer to circumvent many of the costly and time-consuming aspects of asset purchases, such as the assignment of leases and bulk sale notifications; and
- Upon obtaining the required number of votes in support of the merger, the transaction becomes effective and dissenting shareholders are obliged to go along.

A merger may be an inappropriate acquisition vehicle because:

- The seller may insist on receiving cash;
- The buyer and seller may differ on the relative valuation of their companies that would be reflected in a merger formula;
- The seller is exposed to the risk of a future decline in the value of the common stock received as consideration;

- The buyer may be unable to realize some of the major tax benefits available from an acquisition;

- The buyer assumes actual and contingent liabilities of the target;

- The transaction could dilute controlling shareholder positions of the buyer, or allow target company shareholders to become major shareholders of the buyer; and

- The financial performance of the target company may dilute the historical or future earnings per share of the merged entity.

STOCK PURCHASES

The general public views M&A activity in terms of the buyout of the common stock of the target company. The buyer purchases all or substantially all of the common stock of the target company for a specified purchase price. The buyer replaces the selling shareholders as owner of all the assets, liabilities, and other attributes of the target company.

Advantages of a stock purchase include:

- It is quicker, easier, and generally less costly to consummate than an asset purchase, where assignment of leases and contracts, bulk sales notices, and other legal tasks have to be executed;

- In a publicly held company, a tender offer to shareholders can circumvent time-consuming and costly negotiations;

- The buyer can achieve a step up in the basis of the assets to maximize tax writeoffs from the transaction;

- The buyer does not experience any dilution of ownership, as occurs in a merger; and

- A publicly held buyer does not usually require its shareholders to approve a stock purchase.

The principal drawback to a stock purchase is that the assumption of actual and contingent liabilities may cause the buyer to assume significant unintended legal exposure. Detailed due diligence is required to gain comfort on this issue. Also, dissenting shareholders may prevent gaining 100% of the outstanding common stock.

ASSET PURCHASES

Asset purchases are commonly employed for the specific purposes of avoiding unforseen or unwanted liabilities. In an asset purchase, the buyer acquires those assets specified in the bill of sale, and assumes only those liabilities that are explicitly detailed. The tax and accounting basis of the assets is the purchase price. This tax treatment is particularly desirable to a buyer of appreciated assets, but undesirable if the assets have depreciated from their original purchase price.

In an asset purchase, the buyer can focus his due diligence on the specific assets that will be acquired and liabilities to be assumed. The general rule is that if the liability is not specified in the bill of sale, it remains with the seller. This may not hold true, however, with environmental liabilities, where regulatory authorities generally go after the current operator, and leave it to the operator to seek restitution from the previous owner. Certain jurisdictions, most notably California, have a body of case law that exposes the buyer of substantially all the assets of a business to liability from defective products sold by previous owners. Also, the assumption of union contracts generally cannot be avoided by electing an asset purchase.

Bulk sales laws are important hurdles in achieving an asset purchase. The bulk sales laws vary from state to state; but generally, they require proper notification to creditors of any transaction where the majority of merchandise inventory, materials, or supplies will be sold to a third party. The buyer can be held liable if the bulk sales laws are not properly complied with.

You should also be aware of fraudulent conveyance provisions of the U.S. Bankruptcy Code and state statutes. These provisions may give creditors in an asset purchase a claim against the assets or against sale proceeds, or the ability to set aside the transaction. At issue is whether the transaction was for unfair consideration, or if it left the seller insolvent or with insufficient capital to meet its obligations. Fraudulent intent does not have to be proved. The buyer of assets may wind up with an unenvisioned claim against the newly acquired assets.

Contracts that the target company is party to are not automatically assignable to the buyer. Leases, purchase and sale contracts, and loans normally have to be renegotiated, often on less desirable terms. Some may not be available to a new owner.

Asset purchases are desirable when:

- The buyer only wishes to acquire some of the assets of the target company;
- The buyer explicitly does not want to acquire some of the assets of the target company, such as real estate or leases;
- The buyer and seller dispute the value of certain assets which the seller is willing to retain;

- The seller's objective for total transaction proceeds can only be satisfied by allowing him to retain certain assets which can be leased to the buyer or sold to another party;

- The buyer cannot obtain sufficient financing to purchase all of the target's assets;

- The buyer seeks to obtain the favorable tax treatment from acquiring assets with appreciated value; or

- The buyer seeks to avoid assuming certain liabilities.

Asset purchases may be inappropriate because:

- They may trigger undesirable tax consequences to the seller, as we will discuss in Chapter 6;

- They may not enable the buyer to avoid certain major liabilities;

- The seller may insist on being relieved of all obligations of his business by selling the common stock;

- Key intangible assets such as leases or licenses may not be assignable;

- An asset sale may trigger the maturities on certain debts;

- Fraudulent conveyance risks (when buying from a financially troubled company);

- Possible need to comply with bulk sales laws; or

- The cost, time delays, and complexities of completing the transaction may be excessive in relation to the size of the transaction.

FORMS OF CONSIDERATION

The alternative transaction structures constitute alternative means of achieving a desired end. It is important to appear flexible during merger negotiations to prevent them from stalling. If the other party is stuck on a particular factor such as price or transaction structure, you should see if you can comply with that objective by modifying the form of payment or by adjusting other consideration.

The forms of payment normally offered include:

- Cash;

- Common stock;

- A special class of common stock;
- Preferred stock;
- Installment payments, sometimes known as seller notes;
- Contingent payments, also known as earnouts;
- Options or warrants; and
- Convertible securities.

Cash is straightforward. Its value is undisputable. It is the primary or exclusive medium of payment in most deals.

Common stock raises a valuation issue if it is in a closely held company. The seller must evaluate the future prospects of the issuer. Additional issues arise with respect to voting rights, liquidity, and rights of first refusal if the stock is to be sold at a later date.

Preferred stock and seller notes are often required because the buyer cannot finance the entire buyout through equity or conventional financing sources. The need to resort to this type of financing doesn't mean that the buyer lacks the money. Remember, money is for showing, not spending. It may mean that the buyer cannot achieve his or her target rate of return unless the cash investment is limited and the seller retains a residual interest in the company.

Contingent payouts ("earnouts"), convertible securities, options, and warrants are often used to settle the difference between buyers' and sellers' perceptions of value. Their value depends on prospective performance. Contingent payouts are made to the seller in future periods if the company achieves predefined financial goals that are usually based on revenues, operating income, pretax income, or net income. If the contingency is achieved, then the buyer will receive incremental consideration. The contingency is normally specified as a percentage of the contingent objective, such as 20% of operating income in excess of $1 million. Reasons for requiring the payment to be contingent may be that the seller is more confident than the buyer of the ability of the company to achieve the contingency, or the buyer may be unable to meet debt service requirements unless the contingency is achieved. In defining contingent payout arrangements, it is important to be clear about:

- The measurement period;
- Whether the contingency is based on annual performance or cumulative performance;
- Any limits on the total amount of the contingent payouts;
- Accounting policies and allocation methods;

- Provisions for auditing calculations;
- The impact upon the calculations of one-time aberrations, writeoffs, or acquisitions; and
- The date that contingent payments earned become payable.

Several factors besides the form of the transaction and the form of payment can have a significant impact upon value, and can be vital to completing a transaction. They include:

- Payout terms, including the duration of the payout, interest or dividend rate, covenants, security, default provisions, and call provisions;
- Employment contracts;
- Management consulting agreements and noncompete agreements, often consisting of nothing more than a deferred payout;
- Perequisites, which can be the sacred cows to an owner of a privately held company;
- Allowing the seller to retain certain assets which may be sold separately or leased to the company;
- Allowing the seller to retain a partial interest in the company;
- Agreements to lease property from the seller, or to conduct business with the seller's affiliates or family members;
- Post-acquisition adjustments that will increase or reduce the purchase price, based on factors such as audited inventory or account receivable collections;
- Escrow funds which only are released based on specified conditions or terms;
- Indemnifying the purchaser against certain claims and contingencies;
- Establishing responsibility for acquisition costs such as fees to intermediaries, professional fees, asset transfer taxes, and the like;
- Providing the buyer or seller with downside protection against certain contingencies by adjusting total consideration; for example, if the seller is paid in marketable securities, issuing additional securities if their value deteriorates below a specified level within a given time period; and

- Payment-in-kind securities, which pay interest or dividends in the form of additional securities, rather than in precious cash during the initial periods after the acquisition.

To determine which of the laundry list of potential payout mechanisms is appropriate you must know your seller and their motives. Place yourself in their shoes to decide what is likely to be important to them. For example, if you are buying a publicly held company, the only thing that is important is the amount and form of payment. There is a strong bias towards cash payments in public transactions. In divestitures by public companies, an important factor is often the accounting impact of the transaction upon the public company's financial statements. The divesting public company wants to maximize the accounting gain, and limit any loss. Knowledge of the accounting and tax implications of a transaction to the public seller is vital to helping the seller achieve a desired route. Usually the broadest range of structuring possibilities exists with sellers of closely held companies. You can structure the transaction to meet their personal needs.

Become familiar with the array of transaction types, forms of payments, and other consideration. Knowledge of them can keep negotiations on track, and allow you to appear to be flexible. Sometimes the perceived or prospective value of some of these mechanisms can go a long way towards splitting the difference during negotiations. Consider yourself to be the honorable equivalent to the guy on the street who says "buddy, you want to buy a watch?", and then flashes an assortment of watches of every type. Learn to recognize whether you should be flashing a Rolex or a Timex.

Exhibit 5-1 illustrates an example of how you can make a $2½ million cash offer seem like $5 million. The example illustrates the motto: "the other guy's price, but my toims." It provides an opportunity for a "win/win," where a transaction can be structured to meet the seller's expectations, tailored to the buyer's financial constraints. In studying the transaction, observe that the buyer does not have to part with any cash to achieve the transaction. It is entirely funded by existing debt on the company, the seller's carried interest, and by future payments. We will develop funding concepts even further in the section on financing the purchase.

EXHIBIT 5-1
MAKING A $2.5 MILLION CASH OFFER SEEM LIKE $5 MILLION ($000)

	Asking Price	Offer: Nominal Value	Offer: Present Value (a)	
ASSETS				
Cash	$750	750	750	
Accounts receivable	4,000	4,000	4,000	
Inventory	3,600	3,600	3,600	
Fixed assets:				
Land	400	0	0	
Building	3,600	0	0	
Equipment	2,400	2,400	2,400	
	$14,750	10,750	10,750	
LIABILITIES				
Payables and accruals	($3,800)	($3,800)	(3,800)	
Funded debt	(5,950)	(4,450)	(4,450)	
NET ASKING/CASH OFFER PRICE	$5,000	$2,500	$2,500	
Seller retains 20% interest in company		1,000	1,000	(b)
Noncompete agreement		750	503	(c)
Consulting agreement		450	302	(d)
Perquisites		150	102	(e)
Donations in former owner's name		125	85	(f)
10-year lease of land and building		4,000	2,008	(g)
Less: debt retained by seller		(1,500)	(1,500)	
TOTAL OFFER		$7,475	5,000	

(a) Discounted at 15% per year.
(b) Valued at 20% of $5 million asking price.
(c) 5 years @ $150/year.
(d) 5 years @ $90/year.
(e) 5 years @ $30/year.
(f) 5 years @ $25/year.
(g) 10 years @ $400/year.

CHAPTER 6
ACCOUNTING AND TAX CONSIDERATIONS

INTRODUCTION

Accounting and tax considerations can take on a significant role in the economics of a transaction. The accountant is uniquely qualified and interested in this arcane aspect of mergers and acquisitions. Covered are some of the key accounting and tax considerations that you need to be aware of.

POOLING OF INTERESTS

The main guidelines for accounting for mergers & acquisitions were established more than 20 years ago in APB 16. It segregated business combinations into two classifications: purchases and poolings of interests. Along the lines of "a man is innocent unless proven guilty," APB 16 essentially said that a transaction is a purchase unless you can prove that it is a pooling. There are ten criteria for establishing whether a business combination is a purchase or a pooling. They are summarized in Exhibit 6-1. They limit poolings to transactions meeting the prescribed criteria where substantially all of the consideration is paid in voting common stock.

If the transaction complies with the ten commandments of pooling, then it is classified as a pooling of interests. The accounting is quite straightforward: the financial statements of the two companies are simply combined or added together, and historical financial statements are restated to reflect the combined results of the pooled entities. Expenses to achieve the transaction such as fees paid to intermediaries and professionals are deducted from current income. No goodwill is recognized as a result of a pooling transaction.

Pooling is not an option—you have to do it if your transaction meets the pooling criteria. Parties who do not wish to pool their financial statements will deliberately incorporate terms in a buyout agreement which will invalidate a pooling.

The main benefits of a pooling of interests are:

- Future earnings are generally higher than those resulting from a purchase transaction because fixed assets, intangible assets, and goodwill are not written up and subsequently depreciated and amortized based on higher values; and

- The financial statements of the combined entities are more comparable on a year-to-year basis since they are restated historically.

The principal drawbacks of poolings include:

- Asset balances of the acquired entity are not written up to market values, thereby understating their value;

- The historical earnings growth trends, profit margins, and other previous financial attributes of the acquired entity may dilute the adjusted financial statements of the pooled entities—especially if the target was a privately held concern that minimized earnings to save on income taxes; and

- The target company may have unaudited financial statements or an exception in the auditor's opinion that could present problems in obtaining a clean opinion for the pooled entities.

PURCHASE ACCOUNTING

A small minority of transactions are treated as poolings of interests. The rest are purchases. In concept, a purchase is quite straightforward. Essentially, the assets and liabilities are reflected at their fair market values. Any difference between the purchase price and the net of assets and liabilities at their fair market value is reflected as goodwill or a charge against net assets. Special issues may arise in determining the purchase price and the fair market value of assets and liabilities.

The purchase price is generally considered to be the fair market value of all transaction consideration. To calculate fair market value:

- The value of cash is its face value;

- Marketable securities are worth their traded value;

- Noninterest-bearing obligations or obligations with below— or above—market interest rates are worth the present value of future payments, adjusted to reflect an appropriate rate of interest; and

- Any other consideration, including tangible assets or financial instruments, should be valued at their appraised values.

Contingent consideration such as earnouts is not considered in calculating the purchase price. At such time that the contingency is realized, the value of the assets will be adjusted to reflect the value of the contingent consideration.

Important considerations in preparing the balance sheet include the following:

- Assets should be stated at their fair market values—perhaps determined by qualified appraisers—or net realizable values;

- Inventory should be valued according to current market prices for finished goods, less any completion costs, distribution costs, and a reasonable profit margin;

- Intangible assets such as patents, bargain leases, favorable long-term contracts, and other intangible assets of determinable value should be capitalized at their fair market value, generally determined by a qualified appraiser;

- Current liabilities are generally reflected at their face amount; and

- Long-term liabilities, as well as other obligations such as unfavorable leases, warranty liabilities, and capitalized obligations are discounted to their present value, based on an appropriate long-term discount rate.

If the purchase price exceeds the adjusted net value of assets less liabilities, goodwill is capitalized to reflect the difference. Goodwill is written off on a straight-line basis, over a period not to exceed forty years. If the adjusted net value of assets less liabilities exceeds the purchase price, then that difference is written off against noncurrent assets. If a disparity remains after writing down noncurrent assets to zero, then the disparity is reflected as a deferred credit, often referred to as "negative goodwill."

Purchase accounting results in a balance sheet that is more indicative of the fair market value of assets and liabilities. Lenders and creditors tend to gain greater comfort from the higher values reflected on the resultant balance sheet. The exercise of restating historical financial statements is avoided. Any earnings dilution based on the historical financial performance of the target company does not have to be considered.

The main complaints about purchase accounting are that restating the balance sheet can be complex, and the charges to earnings resulting from a writeup of asset balances can depress reported earnings for years to come. A buyer may have loan covenants which are geared to reported earnings and financial ratios that would place him out of compliance, or in danger of violating the target benchmarks. Normally, cooperative lenders and creditors can be guided to focus on the substance of a transaction, rather than the accounting machinations. Since depreciation and amortization are noncash charges, their negative impact on earnings can readily be mitigated by highlighting depreciation and amortization, and disclosing cash flow statements. As the financial markets have become more sophisticated, cash flow has taken on greater importance than reported earnings. As a consequence, the accounting results should be what they were intended to be: a method of measuring progress rather than a means of determining the destination of the voyage. The economics of a transaction should be determined by the transaction rather than by the means of accounting for it.

APB 16 was promulgated in 1970. It was a simpler era, predating the days of FASB's, Emerging Issues Task Forces, and the constant specter of accountant's liability. As we progress, the theoretical frontiers of accounting are constantly tested. New developments in M&A practices and financing methods challenge the theoretical framework of GAAP. Exhibits 6-2 and 6-3 provide an example of how purchase accounting deviates from a pooling of interests.

INCOME TAXES

Taxes can be of considerable import in economics of a transaction. Whereas accounting considerations reflect the way that a transaction is reported, tax considerations impact if income taxes will be paid; when; the amount to be paid; and who will pay them. Real dollars are on the line based on the tax structure of a transaction. It pays to enlist the guidance of an experienced M&A tax adviser early on in the process, before serious discussions about transaction structures begin. You do not want to make promises or build expectations that must later be revoked due to onerous tax consequences. It is best to begin properly advised as to the direction in which you are heading. You only need to have the appearance of an open mind.

Taxes, as they relate to mergers and acquisitions, are essentially a zero-sum game. Alternatives that work in favor of buyers tend to work against the seller, and vice versa. The buyer seeks to maximize his or her basis and future writeoffs. The seller seeks to maximize his or her after tax net sale proceeds. The tax structure of the transaction will be an important consideration in determining the economics of the deal and the purchase price. The objective of good tax planning is to optimize the combined tax treatment to the buyer and seller.

The tax picture of the seller is reasonably straightforward. There are two reference points: his basis in his stock and the basis of the underlying net assets. His capital gain will be computed as the difference between the sale price and the basis. If the basis of the stock exceeds that of the net assets, the seller would prefer to sell stock, since it would result in a lesser tax liability. If the net assets have a higher basis than the stock, the seller would prefer to sell assets to reduce the tax liability. The seller generally pays income taxes when cash is received. By receiving securities or taking back debt, the seller defers taxes on a pro-rata basis until the securities are sold, redeemed, or mature, or until installment debt is repaid. Interest received is treated as ordinary income, and does not affect the computation of capital gains.

A buyer can either purchase stock or assets. If he or she purchases assets, the treatment is comparatively simple. The basis of the assets acquired and liabilities assumed is generally, but not always, their net purchase price. Stock acquisitions are often referred to as "carryover basis" transactions. Unless a Section 338 election is utilized, resulting in an immediate tax to the company, the basis of the assets of the acquired entity is unaffected by a stock transaction. Tax attributes of the acquired entity are retained. Certain beneficial attributes, however, such as net operating loss carryforwards, are subject to limitations that are triggered by a change in control.

Stock acquisitions arise from purchases and mergers. A purchase transaction is straightforward—the acquirer buys the seller's stock for cash and/or debt, and inserts himself or herself in the seller's shoes. Mergers are classified as either taxable or nontaxable taxable transactions. Taxable mergers include forward mergers, reverse mergers, and forward subsidiary mergers. Nontaxable mergers are reorganizations, defined in Section 368 of the Internal Revenue Code. Diagrams of each appear as Exhibits 6-4 to 6-6. You may find it helpful to refer to the diagrams as we proceed with this discussion. The major distinction between taxable and nontaxable mergers is that in nontaxable transactions, selling shareholders agree to accept stock in the merged entity as a significant part of total consideration. All classifications of mergers share the business risks and benefits of mergers that were covered in Chapter 5.

In a forward cash merger, the target company is merged into the buyer and dissolved, and the shareholders of the target are paid in cash and/or debt. For tax purposes, the transaction is treated as a liquidation of the assets of the target company. It results in double taxation. The target company is taxed on the difference between the basis of the assets and the transaction value, and target company shareholders are taxed based on the proceeds that they receive. The buyer records the assets of the target company at their "stepped-up basis." Since the buyer is ultimately "cutting the check" to Uncle Sam on the target's tax liability, he or she will factor any potential tax liability in establishing the purchase price. The forward cash merger has the equivalent tax effect of an asset purchase. The buyer achieves a "step-up" in basis, which may be absorbed by any existing tax credits.

A taxable forward subsidiary merger has the same tax consequences as a forward cash merger, with the distinction being that the merger is achieved through a subsidiary of the buyer, rather than by the buyer directly. For legal or regulatory reasons, a taxable forward subsidiary merger may be preferable to the buyer.

In a reverse cash merger, the acquiring corporation merges with the target company, and the shareholders of the target company are paid in cash and debt. The legal identity of the target company survives the transaction.

TAX-FREE MERGERS

Tax-free mergers are referred to in the Internal Revenue Code as "reorganizations." They result in no immediate tax liability to the seller. The basis that the seller had in his stock in the target company will remain as his substituted basis in the stock received through the merger. Capital gains taxes are deferred until the seller chooses to sell his stock. There are three nonstatutory requirements for a tax-free reorganization:

- The transaction must have a business purpose;

- Selling shareholders must have a continuing equity interest in the merged entity; and

- There must be a continuity of business enterprise.

If the transaction meets these criteria, it qualifies as a tax-free reorganization. The seller will be taxed only to the degree of cash and other property received, known as "boot." Depending upon state merger statutes, the stock can be common or preferred stock, and can be voting or nonvoting.

The most common reorganization type is a consolidation or statutory merger, known in Section 368 of the Internal Revenue Code as a Type A reorganization. It is the most flexible category of tax-free reorganizations. Mergers which cannot meet the more rigid requirements of Type B or C reorganizations are often feasible as Type A reorganizations. A broad array of merger transaction structures can qualify as Type A reorganizations. Examples of the most common forms of Type A mergers are described in Exhibit 6-7.

Type A reorganizations are often used for two-step transactions or "creeping mergers" in which some stock is purchased for cash, and some is later acquired for stock. To gain tax-free treatment, the purchases need to be independent, and executed over a long period of time. If they occurred within a fairly short time frame, they will not prevent tax-free treatment if at least 50% of the total purchase price of the target, including the previous cash purchases of stock, is paid for in stock.

A Type B reorganization is a stock-for-stock transaction which stresses control. In the transaction, the shareholders of the target company exchange their shares for stock in the acquirer. The target company survives as a wholly owned subsidiary of the acquirer. To meet the requirements for a Type B reorganization, the acquirer must obtain at least 80% of the total shares of each class of voting stock, and at least 80% of the total number of shares of all other classes of stock. The medium of exchange must be limited to voting shares in the acquirer or in a company controlled by the acquirer. No boot can be provided in a Type B reorganization.

In a Type C reorganization, the acquirer or a company that it controls exchanges voting stock for all or substantially all of the assets of the target company. The IRS considers "substantially all" to mean at least 90% of the fair market value of the net assets or 70% of the fair market value of the gross assets of the target company. Liabilities do not have to be conveyed.

MISCELLANEOUS TAX CONSIDERATIONS

An example of the tax treatment of several transaction types is contained in Exhibit 6-8. A number of additional tax considerations come into play in mergers & acquisitions. We will discuss a few of the major ones that you should be aware of.

Until the Tax Reform Act of 1986, the General Utilities Doctrine permitted corporations to sell appreciated property during a 12-month period in a liquidating sale, and to remit the net proceeds to its shareholders without paying taxes on the gains at the corporate level. The repeal of the General Utilities Doctrine results in a double taxation in asset sales—first at the corporate level, then at the shareholder level. It has increased the cost of acquisitions, and reduced the attractiveness of asset sales. Sellers are now more eager to sell stock to avoid double taxation.

Besides an asset purchase, the only opportunity that the buyer has to realize a step-up in basis is through a Section 338 election. Under a Section 338 election, the acquirer can write up assets to their fair market value provided that it has purchased at least 80% of the target corporation's stock. Because the acquirer makes the Section 338 election after the acquisition, it becomes liable for the taxes. There are only two instances where a Section 338 election is advisable:

(1) Where there are net operating loss carryforwards available to wholly or largely offset the gain resulting from the step up, and the present value of the writeoffs from the increased basis exceed the present value of available net operating loss carryforwards.

(2) Where the fair market value of the assets exceeds their basis and the seller is a member of an affiliated group of corporations which files a consolidated income tax return. Provided that both parties agree to making a Section 338 (h)(10) election, the buyer achieves the step up in basis without paying taxes, and the seller pays taxes only on the gain resulting from the excess of the sale price over the basis in the target's assets.

The basis of assets conveyed in an asset sale or a Section 338 election is specified in Section 1060 of the Internal Revenue Code. The value of the assets is based on the total consideration paid for them. It should be identical for both the buyer and the seller, although the allocation may wind up being different. Generally, allocations should be supported by an appraisal. Section 1060 requires the purchase price to be allocated on a residual basis among five classifications of assets in the following order:

(1) Cash, demand deposits, etc.

(2) Certificates of deposit, U.S. government securities, readily marketable securities, and foreign currency.

(3) All other assets, both tangible and intangible (whether or not depreciable, depletable, or amortizable), not fitting into one of the other categories including accounts receivable.

(4) Section 197 intangibles, exclusive of goodwill. Section 197 intangibles include patents, copyrights, licenses, permits, customer-based intangibles, supplier-based intangibles, franchises, trademarks, trade names, and covenants not to compete

(5) Intangible assets in the nature of goodwill or going concern value.

If the purchase price exceeds the sum of the fair market value of assets in classes 1 through 4, then there will be goodwill. If the purchase price is less than the fair market value of assets in classes 1 through 4, it will be applied first to assets in class 1 up to the amount of their fair market value, with any residual amount then being applied to the assets in class 2 up to the amount of their fair market value, then to class 3 assets up to the amount of their fair market value, and finally, any remaining amount would be applied to assets in class 4 up to the amount of their fair market value. If the allocatable purchase price is less than the sum of the fair market values of the assets in a particular class, then the allocatable purchase price is allocated among the assets in that class based on their relative fair market values. An example of the application of Section 1060 is provided in Exhibit 6-9.

The Omnibus Budget Reconciliation Act of 1993 tightened the guidelines affecting the tax treatment of goodwill and other intangible assets. Previously, buyers were motivated to allocate as much intangible value as possible to identifiable intangible assets such as customer lists and covenants not to compete. These assets could generally be written off more rapidly than goodwill. Buyers would complain that the 40-year amortization period that was often attributed to goodwill placed U.S. buyers at an economic disadvantage in relation to overseas buyers that could write off intangible value more rapidly. The IRS believed that many buyers took liberties in allocating substantial value to identifiable intangible assets that were then written off over what seemed to be unusually short lives. The compromise position was that intangible assets resulting from business acquisitions completed after August 10, 1993 would be amortizable on a straight-line basis over a 15-year period. The Act affects a broad range of intangibles, including goodwill, going concern value, information and knowhow, customer lists, favorable contracts, franchises, trademarks, noncompete agreements, and government-granted rights such as patents, copyrights, and licenses. All intangible assets are subject to the 15-year rule unless they are specifically excluded. The Act permits only a few exceptions (see IRC § 197).

Hybrid acquisition structures combine features of both taxable and tax-free transactions. Under Section 351 of the Code, certain shareholders may transfer their interests on a tax-free basis into a newly formed corporation. The new corporation may, in turn, acquire the remaining outstanding shares of the target corporation in a transaction that is taxable to the target company shareholders. Such an acquisition would not have to meet the continuity of interest requirement for tax-free reorganizations. Typical uses of hybrid acquisition structures are management buyouts and certain estate-planning buyouts.

The availability to acquirers of the net operating loss carryforwards of acquired entities has been severely curtailed as a result of the Tax Reform Act of 1986. The amount of the net operating loss carryforward that can be used by a new owner in any given year is limited in Section 382 based on a formula. The formula applies the purchase price to the highest adjusted Federal long-term tax-exempt rate in effect during the three months ending the calendar month in which the transaction occurs. For example, if the applicable Federal long-term tax-exempt rate is 6%, and a company with a $3 million NOL is acquired for $4 million, only $240,000 of the NOL can be used each year, that is, 6% times $4 million. The NOL can be lost entirely if the historical business of the target is not continued for at least two years.

There are a number of provisions in the Tax Code which deal with the treatment of various means of financing acquisitions. Some that may not be intuitively obvious are those that deal with installment sales, original issue discounts, and Employee Stock Ownership Plans.

In an installment sale, some or all of the purchase price is paid for over a period of several years. An installment sale allows the seller to defer his gain, on a pro rata basis, until he or she receives payment on the installment notes. For example, if the company is sold for $10 million, and results in a $4 million gain, the capital gain portion of each installment payment is 40% of the payment.

Any debt that is issued in connection with a buyout is subject to original issue discount rules. If the interest rates on an installment note are below the U.S. Treasury rate on notes of similar duration, the IRS will recharacterize the note to reflect a lower principal amount and a higher amount of interest. In so doing the IRS restates the note to its present value. The seller winds up recognizing more interest income, and a lesser capital gain. The buyer does not obtain as high a basis in the acquired assets. The original issue discount rules are also applied to zero coupon bonds, payment-in-kind securities, and interest that is accrued but not paid. These rules have an undesirable impact upon tax-paying sellers, since interest income must be recognized, although no cash is received.

Employee Stock Ownership Plans, known as "ESOPs," enable employees to obtain an equity interest in their employer through a tax-advantaged program that is regulated by the Employee Retirement Income Security Act. ESOP's can be an excellent funding vehicle for acquisitions. The tax incentives resulting from ESOP's include the following:

- An owner who sells at least 30% of a company to an ESOP can defer the profit on the sale, provided that the sale proceeds are invested in nongovernment securities.

- 50% of the proceeds up to $750,000 resulting from a sale by an estate to an ESOP may be deducted from estate taxes.

- An institutional lender can exclude from its income 50% of all interest income received from ESOPs which own more than 50% of each class of their sponsor's stock or 50% of the total stock outstanding. The ability of the lender to exclude from taxation half of the ESOP interest income results in interest rates on ESOP loans that are generally below the prime rate of interest.

- Employer contributions to repay principal on ESOP loans are deductible by the employer. The deductions are limited to 25% of employee compensation, computed on the first $200,000 of total compensation for each employee.

A seller's transaction costs are added to its stock basis in a tax-free reorganization, and added to its asset basis in a taxable transaction. The buyer's transaction costs are added to the cost basis of acquired assets or stock. Fees and expenses incurred in connection with debt are generally capitalized and amortized over the term of the loan. Equity issuance costs are deducted from the net proceeds received; they are neither capitalized nor written off.

There are a number of additional tax issues that should be focused upon to plan a purchase or sale. They include:

- The impact of the alternative minimum tax;
- Foreign tax credits;
- Asset dispositions prior to a sale;
- Asset dispositions to finance a purchase;
- The compatibility of the acquirer's and target's tax years and accounting methods;
- Section 384 limitations on the buyer's ability to use NOLs;
- Built-in gains and losses in the target's assets; and
- Applicable foreign, state, and local income tax provisions which affect the buyer and seller.

The accounting and tax considerations which affect mergers & acquisitions are complex. The accounting rules in this area have evolved solely, whereas the tax guidelines have changed continuously, often in dramatic fashion. It is an area where the statutes and case law are evolving continuously. Regard the tax aspects of M&A as a moving target. You must regularly reload for more ammunition.

EXHIBIT 6-1
POOLING CRITERIA

(1) Both companies need to have been autonomous from any other company for at least two years. As a consequence, you cannot pool with a subsidiary or division of another company.

(2) The companies have to be independent of each other.

(3) The plan must be executed in a single transaction which is consummated within one year.

(4) At least 90% of the consideration paid in the transaction must be voting common stock.

(5) No changes in equity may have been made in contemplation of the transaction.

(6) You cannot have an abnormal reacquisitions of stock after the plan of merger is initiated. In other words, you cannot cash out one or a few major shareholders just prior to, or after, the merger.

(7) Common stock must be issued to the parties to the transaction on a pro-rata basis.

(8) The stock issued must have unrestricted voting rights.

(9) The transaction must be effectuated by the date of consummation. You cannot have a pooling in anticipation of planned compliance with the pooling requirements.

(10) Any post-combination transactions which are inconsistent with the criteria for a pooling of interests can invalidate this accounting treatment.

Note: Adapted from *Accounting Principles Board Number 16: Business Combinations*, issued in August, 1970.

EXHIBIT 6-2
BALANCE SHEET COMPARISON
POOLING OF INTERESTS AND PURCHASE ACCOUNTING
DECEMBER 31, 19X1

	Company A BV(1)	Company B BV(2)	Company B FMV(3)	Pooling of Interests (1) + (2)	Purchase Accounting (1) + (3)
Assets:					
Cash and equivalents	$300	100	100	400	400
Accounts receivable	900	400	380	1,300	1,280
Inventory	780	360	390	1,140	1,170
Net fixed assets	2,000	650	900	2,650	2,900
Intangible assets	200	0	150	200	350
Goodwill	0	0	160	0	160
	$4,180	1,510	2,080	5,690	6,260
Liabilities:					
Current liabilities	$1,200	320	320	1,520	1,520
Long-term debt	600	180	160	780	760
	1,800	500	480	2,300	2,280
Stockholders' equity:					
Common stock	250	100	100	350	350
Add'l paid in capital	350	75	1,500	425	1,850
Retained earnings	1,780	835	0	2,615	1,780
	2,380	1,010	1,600	3,390	3,980
	$4,180	1,510	2,080	5,690	6,260

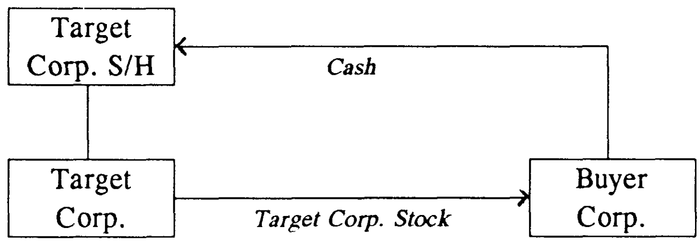
Note: Company B is worth $1,600.

EXHIBIT 6-3
PRO-FORMA INCOME STATEMENT COMPARISON
OF POOLING OF INTERESTS AND PURCHASE ACCOUNTING
FOR THE YEAR ENDED DECEMBER 31, 19X2

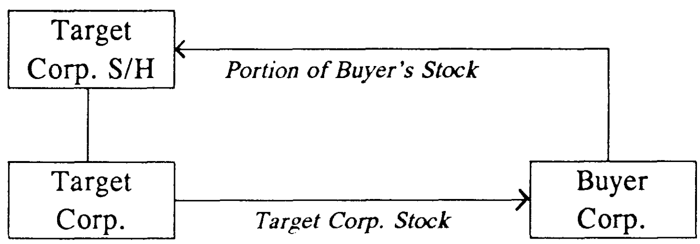
	Company A (1)	Company B (2)	Purchase A/C Adj/ (3)	Co. AB Pooling (1)+(2)	Co. AB Purchase (1)+(2)+(3)
Sales	$4,000	1,750	0	5,750	5,750
Operating expenses	3,200	1,400	0	4,600	4,600
Depreciation	300	100	50	400	450
Amortization of intangibles	30	0	25	30	55
Amortization of goodwill	0	0	4	0	4
Operating income	470	250	(79)	720	641
Interest expense	60	20	0	80	80
Amortization of discount on LTD	0	0	5	0	5
Income before taxes	410	230	(84)	640	556
Income taxes	120	70	0	190	190
Net income	$ 290	160	(84)	450	366

EXHIBIT 6-4
FORWARD MERGERS

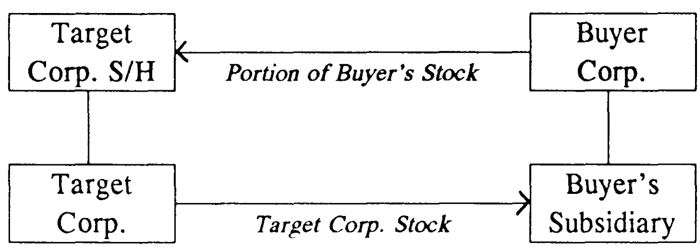
Taxable Forward Merger



Tax-Free Forward Merger
("A" Reorganization)

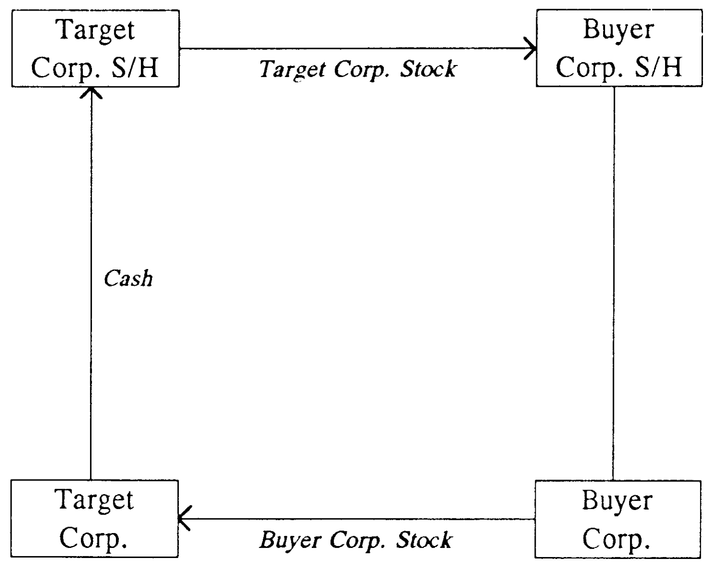


Tax-Free Forward Triangular Merger
(Hybrid "A" Reorganization - section 368 (a)(2)(D))



Transaction Summary:
Target Corp. shareholder (S/H) owns 100% of Target Corp. stock
Target Corp. merges into Buyer Corp. or its subsidiary
Target Corp. S/H is paid in cash (taxable) or portion of Buyer Corp. stock (tax-free)
Target Corp. stock is cancelled

EXHIBIT 6-5
TAXABLE REVERSE MERGER



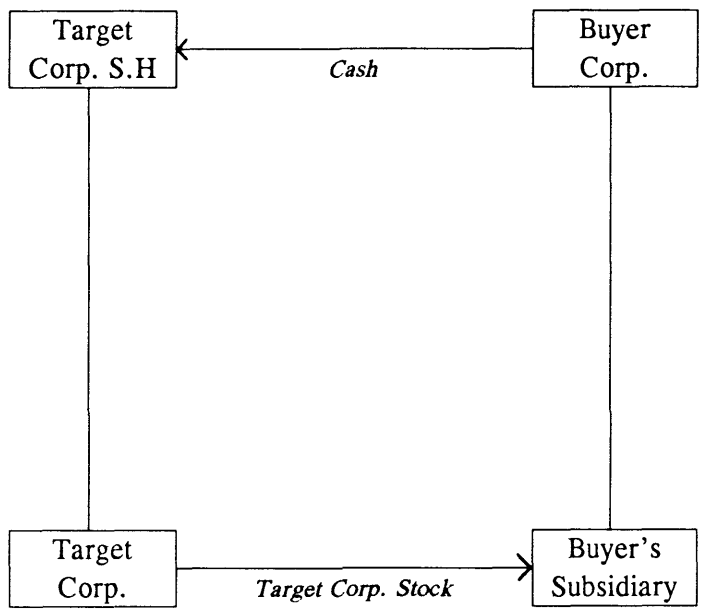
Transaction Summary:

Buyer Corp. merges with Target Corp.

Cash from merged entity is paid to Target Corp. shareholder (S/H)

Target Corp. S/H transfers stock to Buyer Corp. S/H

EXHIBIT 6-6
TAXABLE FORWARD SUBSIDIARY MERGER



Transaction Summary:

Target Corp. shareholder (S/H) owns 100% of Target Corp. stock

Target Corp. merges into subsidiary of Buyer Corp.

Buyer Corp. pays cash to Target Corp. S/H

EXHIBIT 6-7
EXAMPLES OF TYPE A REORGANIZATIONS

- In a statutory merger, selling shareholders relinquish their stock in the target company in exchange for the buyer's stock, and possibly boot. The assets and liabilities of the target company are subsumed into the acquiring company.

- A statutory consolidation occurs when the assets and liabilities of two corporate entities are transferred into a new entity. Stock in that entity, as well as boot, if applicable, is given to shareholders in exchange for their stock in their previously separate companies.

- In a subsidiary or triangular merger, the buyer establishes a wholly owned subsidiary into which the target company merges. Selling shareholders receive stock in the buyer in exchange for their stock in the target company. This type of transaction is used mostly by publicly held buyers which wish to avoid seeking the approval of their shareholders to merge with another company.

- A reverse triangular merger is achieved by having a newly formed acquisition subsidiary formed by the acquirer merge into the target company. Target company shareholders receive the stock of the acquirer in exchange for their stock. The acquisition subsidiary disappears. The transaction has the effect of causing the target to become a wholly owned subsidiary of the acquirer.

EXHIBIT 6-8
TAX TREATMENT OF VARIOUS TRANSACTION TYPES

	Taxes paid by Target shareholders?	Taxes paid by Target Co.?	Basis of Buyer in Target assets?
Stock purchase	PP - SB	No	Carryover
Asset purchase	PP - SB	PP - AB	Stepped up
Tax-free reorganization (A, B or C)	No	No	Carryover
Stock purchase, Sec. 338 election	PP - SB	PP - AB	Stepped up
Forward cash merger	PP - SB	PP - AB	Stepped up
Taxable forward subsidiary merger	PP - SB	PP - AB	Stepped up
Reverse cash merger	PP - SB	No	Carryover

Notes:
PP = Purchase price.
AB = Asset basis.
SB = Stock basis.

EXHIBIT 6-9
EXAMPLE OF ALLOCATION OF PURCHASE PRICE

Transaction	**#1**	**#2**	**#3**
Gross purchase price	$20,000	$20,000	$ 20,000
Appraised values:			
Class 1 assets	500	15,000	600
Class 2 assets	250	7,000	100
Class 3 assets	18,000	1,000	9,000
Class 4 assets	3,000	250	3,000
	$21,750	$23,250	$ 12,700
Allocation:			
Class 1 assets	$ 500	$15,000	$ 600
Class 2 assets	250	5,000	100
Class 3 assets	18,000	0	9,000
Class 4 assets	1,250	0	3,000
Class 5 assets	0	0	7,300
	$20,000	$20,000	$20,000

Notes:

Class 1 assets = cash, demand deposits, etc.
Class 2 assets = certificates of deposit, marketable securities, and foreign currency
Class 3 assets = all other tangible and intangible assets except Class 4 and 5 assets
Class 4 assets = Section 197 intangibles, excluding goodwill and going concern value
Class 5 assets = intangible assets in the nature of goodwill or going concern value

CHAPTER 7
FINANCING THE PURCHASE

INTRODUCTION

Finding a good company, performing due diligence, negotiating a fair purchase price, and structuring it on an optimal basis are wasted efforts if the deal cannot be financed. Many good deals slip away because the buyer cannot obtain financing. This chapter covers some of the key types of financing available, including where to obtain them, how much they cost, and what their limitations and requirements are.

Financing is critical to both the buyer and seller. The buyer should not go very far down the path of pursuing a transaction without having a clear view as to how it is likely to be financed. This will have a significant bearing on how much to offer, how the deal will be structured, and whether or not it is even feasible. The seller needs to be knowledgeable about financing in order to have realistic expectations about the price and terms that are attainable for his or her company. Also, the seller or his advisers may be able to help the buyer obtain financing if the buyer is unable to do so on his or her own. The more desirable the financing terms available to the buyer, the higher is the price and richer the terms that he or she can afford to pay to the seller.

FINANCING TIERS

There are many financial instruments which can be used to finance an acquisition. They do not all apply to all transactions. The financial structure of small transactions can be quite straightforward. Also, the financing structure may seem to be invisible to the seller, who may be paid out entirely in cash, and therefore, have no continuing interest in the company. To cover all basis, we will cover the major sources of financing. They include:

- Senior revolving credit;
- Senior term debt;
- Subordinated debt;
- Sale/leaseback transactions;
- Seller subordinated notes;

- Preferred stock; and

- Common stock.

One way of viewing the financing for an acquisition is as a multistory building. To start with, it requires a solid foundation. The business is the foundation upon which the building is built. A business which is not solid from a financial standpoint cannot support a very tall structure. The lower floors are reserved for the equity holders. Depending upon the nature of the deal, the equity holders can occupy a few or the majority of the floors. If the building is on a soft foundation and sinks into the ground, the equity holders will be the first to be affected. Above the equity holders are the middle tier lenders. They are often referred to as the providers of "mezzanine financing." The top floors are reserved for the secured creditors. They have the best views, and are insulated from the street noise. They will be the last to be affected if the building sinks beneath the surface.

Financing is priced according to the level of risk assumed, and the upside potential which it provides. Senior secured debt is the least risky. It should be secured by assets whose value exceeds the indebtedness, often by a large margin. It is normally priced at the prime rate of interest or at a premium that is no higher than 2% or 3% over prime. Mezzanine debt is more costly. If mezzanine lenders believe that interest alone requires an insufficient return to compensate them for risk, they may require "equity kickers" such as conversion privileges, options, or warrants. Preferred stock is even more costly as a means of financing. Unlike interest payments, preferred dividends are not tax deductible. To a taxpayer in the 40% tax bracket, the effective cost of 10% interest is 6%. However, the effective cost of a 10% preferred dividend is 10%. Preferred stock also may be accompanied by equity kickers. Finally, the most costly of all capital is equity capital. The effective cost of equity capital is the required rate of return for equity investors. Since most investments, particularly which that employ substantial leverage, pay little in the way of dividends, the rate of return is achieved through capital appreciation. During the 1980's, the average rate of return on major leveraged buyout funds exceeded 40%.

A company does not need to have developed a new gene splicer in order to achieve high rates of return on equity. Exhibit 7-1 contains an example of a company, growing at a modest rate of 8% per year. Leverage enables the equity investor to achieve an annual internal rate of return on investment of 54.3%. This rate of return is not achieved by using mirrors. It constitutes hard dollars that would be realized if the investment were sold at the end of the fifth year.

SENIOR DEBT

In order to maximize the return on equity, it is necessary to employ lower-cost sources of debt financing to the highest degree that is prudent. The art of financing is being able to determine how much leverage an investment can reasonably support, recognizing that the decision is being made on an *a priori* basis. With debt, as with production workers, populations, or beer, there is a point at which the marginal utility of incremental debt reaches the point of diminishing returns. To leave margin for error in an uncertain environment, it is important to stop well short of that breaking point in deciding how much debt to employ.

The primary tool for determining an appropriate financial structure is the financial projection. You must develop a financing package which is achievable, and which meets the requirements of each source of capital that will be drawn upon.

Prior to approaching lending sources, it is important to prepare a financing package. The contents of the financing package include much of the information that was listed in the sample outline of an information memorandum in Chapter 2. The main information that financing sources focus on will include:

- The buyer's background and financial resources;
- The target company's business;
- Management quality;
- Historical cash flow;
- The value and liquidity of assets;
- Projected cash flow;
- The transaction;
- The new capital structure; and
- The means of being repaid or realizing the value of appreciated equity.

Many of these factors relate to what have traditionally been referred to as the "5 C's of lending":

- Character;
- Capital;
- Cash flow;
- Collateral; and
- Conditions.

The borrower must be of unimpeachable *character*. Background checks and the experience of current and former lenders and partners are likely to be investigated. The acquired entity must have adequate *capital* to support the business and adequate *collateral* to provide the lender with downside protection. Finally the *conditions* affecting the target company's business and the capital markets will determine whether the timing is right to make the loan.

The financing information package is of vital importance. It is your way of influencing the capital sources as to why they should do the deal. Its quality and appearance will influence their perception of the quality and capability of the buyer and his or her professionals. It must be concise and truthful. Most active financing sources see a substantial flow of deals. You need to quickly spark their interest and get them to consider your transaction. The information package must speak for itself. You can assume that several people will be reviewing it that you will not have a chance to converse with directly. Because time is of the essence, you don't want to lose a deal because you were too slow or inept at getting financing. It is important to have an experienced person who can prepare a quality financing information package within a short time frame.

Equity capital is a scarce and expensive source of financing. To minimize the required equity, you must attract relatively more debt capital. All participants in the capital markets do not view deals in the same way. It is possible to get one acceptance after 30 lenders have said no. Financing sources have varying tolerance for risk, and differing perceptions of the upside potential of a particular transaction. Some are willing to be more aggressive as a result of a favorable past experience with the borrower. Just as lenders always try to know their borrowers, borrowers should be aware of the appetites and constraints of financing sources. This will help to more clearly target financing sources and avoid wasting time.

Attributes which may make a company attractive as a business or as an investment do not necessarily make it desirable as a candidate for debt financing. The checklist entitled "What Makes an Acquisition Candidate Attractive?" contained in Chapter 2 lists many of the features which are desirable to lenders. However, traits of particular importance include the following:

(1) *Financial participation of current shareholders.* It is an expression of confidence, and an indication that they are not "bailing out."

(2) *Management participation.* It reduces the risk profile of the company if it is being managed by capable individuals who are familiar with the ins and outs of the company.

(3) *Low debt level.* Additional leverage cannot be employed if the company is already heavily leveraged.

(4) *Slow but consistent growth.* High growth, while great for an unleveraged company or a publicly traded company, requires capital that many newly acquired companies just don't have.

(5) *Significant market share.* You don't want to be the marginal player in an industry dominated by a few players.

(6) *Consistent profitability.* Profits, when translated into cash flow, repay debt.

(7) *Not technology intensive.* This reduces research and development costs, as well as the risk that the company will be left behind as a result of a new development by competitors.

(8) *Noncyclicality.* The debt service meter must constantly be replenished in good times and bad times.

(9) *Limited capital requirements.*

(10) *Liquid collateral.* This translates to rapid-paying receivables, marketable inventory, multipurpose plant and equipment, and severable intangible assets.

(11) *Surplus assets.* These are a source of debt repayment.

(12) *Improvement potential.* Lenders prefer not to lend based on the argument that the buyer will improve the business. They hope that the historical cash flows, if sustained, are sufficient to repay debt. However, improvement potential is desirable.

(13) *Buyer commitment.* Placing capital and reputation at risk increases the commitment of buyer to repaying debt.

(14) *Account profitability.* The more ways that a lender sees to make money from a relationship—including letter of credit fees, cash management fees, ability to participate in other deals, etc.—the more attractive the loan becomes.

The skyscraper that we will erect to finance the purchase is designed from the top down. We start by determining the tenants on the upper floors. The first stop is the secured creditors.

A revolving line of credit is a loan facility that is generally secured by accounts receivable and inventory. The amount of credit which is available through the revolving line of credit may fluctuate on a daily basis, depending on the balances of eligible accounts receivable and inventory. The "line" is generally expressed in terms of advance rates on eligible assets, subject to a maximum and certain adjustments. The mechanics of the calculation of the borrowing base is very important. It will vary depending upon the lender, the borrower, and the credit. Exhibit 7-2 shows an example of the dramatic disparities in credit availability which can result from different calculations of the borrowing base and advance rates. Advance rates on eligible receivables tend to range between 70% and 85%. Advance rates on finished goods inventory in nonvolatile industries tend to be about 50%. Higher rates may be available on commodity products. On the other hand, the advance rates on raw materials and work-in-process may be considerably lower. Sources of financing for revolving lines of credit generally include commercial banks, finance companies, and thrift institutions.

Fixed assets are normally secured through term loans. The term on a real estate loan may be ten to thirty years, as contrasted to a normal term of four to ten years on most categories of equipment. Lenders will normally loan 50% to 80% of the appraised value of real estate, and 50% to 80% of the appraised liquidation value of equipment. Sources of term loans include banks, commercial finance companies, insurance companies, thrift institutions, and institutional investors such as large pension funds.

Real estate has become a more difficult asset to secure financing for in recent years. Lenders are quite properly concerned about potential environmental liabilities. There have been several cases where lenders foreclosing on contaminated real estate have faced responsibility for the cleanup. Once the problem is detected, it has to be rectified. Cleanup costs can exceed the amount of the loan. As a result, environmental due diligence becomes important to lenders as well as buyers.

Other assets which have determinable value and which are saleable can also serve as collateral for an asset-based loan. These assets can include real estate leases, patent rights, and various other intangible assets. A summary of asset-based lending formulas is provided in Exhibit 7-3.

The market for loans is not perfectly efficient. Both pricing and terms are negotiable. You can't get if you don't ask. As in buying a company, you need to retain flexibility, put yourself in the lender's shoes, be reasonable, and know when to listen and when to negotiate. The key issues for negotiation include:

- Amount of the loan;
- Term of the loan;
- Interest rate;
- Commitment fees;
- Borrowing base computation;
- Advance rates;
- Overadvance rates;
- Initial willingness to defer interest or principal;
- Collateral;

- Personal guarantees;
- Definition of expenses which are reimbursable to the lender;
- Default provisions;
- Affirmative covenants;
- Negative covenants;
- Prepayment penalties; and
- Services to be provided by the lender.

In your dealings with lenders, bear in mind that they are not equity investors. Their only payback comes if you comply with the terms of the loan. Collateral serves to protect them on the downside. However, they are not in the liquidation business. More often than not, in a liquidation they will sustain losses. As a result, they will usually choose not to make a loan if they consider it unlikely that cash flow from the business will be sufficient to repay them.

JUNIOR OBLIGATIONS

Debt financing which cannot be placed with senior lenders may be obtainable on a subordinated basis. Often referred to mezzanine financing, this category may include senior subordinated debt, junior subordinated debt, private placements, or high-yield debt, more commonly referred to as "junk bonds."

There may be some residual equity in the value of assets, net of obligations to secured lenders. Subordinated lenders may obtain a junior lien against these assets. However, the main vehicle that subordinated lenders look to for repayment is the cash flow of the target company. This cash flow can include normal cash flow from operations, as well as cash flow from asset sales and divestitures. In smaller transactions, subordinated loans may be provided by individuals or investment groups. They also may be received from a bank which has a relationship with the borrower and is willing to lend on an unsecured basis. The array of terms on these transactions is quite broad. The source of funds on larger transactions tends to be insurance companies, pension funds, large finance companies, commercial banks, leveraged buyout funds, and the public. The attributes of this type of funding include:

- Subordination to senior debt;
- Normally, it is not secured by assets;

- Interest rates of 13% to 17%;
- Maturities of 10 to 15 years; and
- Prohibitions against prepayment during the first three to five years.

Since subordinated lenders provide funding that is at the fringe of what the deal can support, they sometimes have to defer payments in the initial years following the buyout. Zero coupon notes or notes with payment-in-kind options during the first three or four years are frequently designed to allow for cash shortfalls during initial years. It is hoped that the company will gain the ability to service subordinated debt as a result of growth, divestitures, or by having reduced debt service requirements after some senior debt is repaid.

Subordinated lenders are in a precarious position on the risk/reward scale. They lack the security of senior lenders, as well as the upside of equity holders. They are further exposed in some instances where they may be subordinated below claims of trade creditors and all other classes of unsecured creditors. Subordinated loan or bond indenture agreements attempt to provide a measure of downside protection. To induce the participation of subordinated lenders, they are often provided equity kickers in the form of options, warrants, or conversion privileges. Until the debacle in the junk bond market in late 1989, subordinated lenders generally fared quite well. The annual rates of return of "sub debt" funds generally ranged between 20% and 30% during the 1980s.

The seller often winds up being a source of financing to facilitate completing the deal. First of all, he may participate in, or help to arrange, a sale/leaseback transaction. In the transaction, a major or she asset of the company such as the real estate is sold to an outside party, and leased back to the company. A sale/leaseback reduces the amount of capital which the buyer has to raise to finance the transaction.

The seller may also wind up taking back a note which will be subordinated to all other outstanding debt. In taking back a seller note, the seller realizes that he or she may be unable to immediately cash in all of the equity at its highest potential value. A seller note creates a fixed obligation of a defined amount for a multiple-year period. Terms of a seller note may require it to be repaid before the buyer can receive distributions. Seller notes may be part of an installment purchase or linked with contingent payouts. Their term may range from three to seven years. They may be further sweetened through equity kickers.

At times, the seller may be obliged to take back preferred stock rather than debt. This could occur if the company appears to be undercapitalized as a result of the leverage of the buyout transaction. The appearance of additional equity may be required to sell subordinated debt or to convince trade creditors that the company is not overextended. Preferred stock has the disadvantage of being junior to all debt. The dividend payments do not constitute an obligation of the company. The buyer cannot deduct preferred dividend payments.

Preferred stock often has many of the characteristics of junk bond debt. Dividend yields may be roughly similar. It may include payment-in-kind provisions during the early years following the buyout. The term is generally 10 to 15 years. Although the lack of a dividend payment deduction may not be onerous to the buyer in the initial years after the buyout when its tax liability is likely to be low as a result of heavy interest payments, it could be increasingly burdensome in later years when the company is profitable. There are usually provisions which allow the buyer, at its option, to redeem the preferred stock beginning the third or fourth year after issuance, or to convert it to subordinated debt in order to receive the interest deduction. The preferred issue may also be sweetened by equity kickers. Limited control may be provided by allowing voting privileges, or the appointment of board members if dividends are not paid within a specified time after they are due.

In a highly competitive transaction, there may be insufficient time to complete all layers of financing. A bridge financing may be used as a temporary measure until permanent financing arrangements can be put in place. Bridge financings are normally associated with larger transactions. The source of funding on these transactions is generally the investment banker who will underwrite the junk bonds. The term of the bridge loan is usually less than nine months, with an interest rate that is usually below the rate that will be paid on the junk bonds. In consideration for providing the bridge loan facility, the underwriter is usually given an equity kicker that may amount to 3% to 5% of the target company stock.

Bridge loans can be risky to the underwriter because there is no assurance that they will be taken out within the desired time frame. The financing climate can change or the target company may deteriorate, thereby precluding a near-term refinancing. Providing the bridge loan is often the price that the underwriter must pay to assure the opportunity to underwrite the junk bond offering. The terms and covenants of the bridge loan generally resemble those anticipated for the refinancing that will replace the bridge facility. There also may be rollover provisions in the event that the underwriter cannot refinance the bridge facility, and provisions to take the underwriter out at a future date from refinancing or divestiture proceeds.

EQUITY

The last and generally most precious form of capital is equity. How much equity you have to contribute will depend upon how successful you were in raising capital from the previously enumerated sources. In leveraged buyout, equity normally constitutes 5% to 25% of total capitalization. However, not every company is a leveraged buyout candidate. Higher equity levels may be required.

If you need to go to outside sources for equity funding, the normal sources besides friends and relatives include:

- The seller, by getting him to retain a carried interest in the company;

- Management;

- Employees, through an ESOP or through their pension plan;

- Leveraged buyout funds;

- Venture capital funds; or

- Corporations which may have a strategic reason for wanting to participate in the transaction.

Bear in mind some of the sources of financing which were covered in previous chapters do not appear on the capital section of the balance sheet. They include noncompete agreements, employment contracts, perquisites, and getting the seller to retain certain assets. These are particularly relevant to transactions involving privately held companies. Other sources of financing that appear on the balance sheet include surplus cash and marketable securities; the sale or sale/leaseback of fixed assets; a reduction in the investment in receivables and inventory through more efficient management practices; and increasing the amount of trade debt.

Determining how much financing a deal can support can be one way of determining how much to pay. Exhibit 7-4 contains an example of how this computation can be made. Exhibit 7-5 demonstrates that there is no single right way to finance a deal at a fixed purchase price. On an identical purchase price, you can have an almost infinite array of potential mixes of debt and equity instruments. The blend of debt and equity, and the timing of debt service payments can have a significant impact on the return realized by equity investors. Exhibit 7-6 reveals how the nature of the capital structure which you employ can impact how much you are able to pay, while leaving your target rate of return unchanged. In the examples shown, the addition of preferred stock and amending principal repayment terms enables us to increase the offer price by 7%, reduce our equity commitment by 43%, and yet still achieve the target internal rate of return of 25%. In a highly competitive transaction or with a highly desirable candidate, mastery of financial engineering can make the difference between getting and not getting the company.

Just as the buyout is only the first stage of the process to make money on an acquisition, it is also only the first crack at maintaining a suitable capital structure. After the transaction is completed you should be continuously revisiting how the company is financed. Businesses are not static. Things change. Unanticipated developments arise. You should be looking for opportunities for:

- Refinance debt on more desirable terms;

- Divesting or spinning off nonvital assets;

- Undertaking a public offering if the timing is right;

- Selling the company at some future date.

Remember, nobody ever went broke by taking a profit. You do not realize a profit on an acquisition until the day that you sell it and pocket the proceeds. Conversely, if you made a mistake, be prepared to own up to it and respond accordingly. Sometimes the first loss is the best loss.

EXHIBIT 7-1
XYZ CORP.
EXAMPLE OF RETURNS REALIZABLE BY EMPLOYING LEVERAGE

	At Buyout Date	Year 1	Year 2	Year 3	Year 4	Year 5
Sales	$10,000	10,800	11,664	12,597	13,605	14,693
Operating expenses	(8,500)	(9,180)	(9,914)	(10,707)	(11,564)	(12,489)
Operating income	1,500	1,620	1,750	1,890	2,041	2,204
Interest	0	(960)	(900)	(840)	(756)	(672)
Pretax income	1,500	660	850	1,050	1,285	1,532
Income taxes @ 40%	(600)	(264)	(340)	(420)	(514)	(613)
Net income	900	396	510	630	771	919
Depreciation	500	525	551	579	608	638
Capital expenditures	(250)	(275)	(303)	(333)	(366)	(403)
Working capital reinvested	(100)	(160)	(173)	(187)	(202)	(218)
Repayment of debt	0	(500)	(500)	(700)	(700)	(1,000)
Net change in cash	$1,050	(14)	85	(11)	111	(64)
Value @ 6 x EBIT*	$9,000	9,720	10,500	11,340	12,246	13,224
Surplus cash	0	(14)	71	60	171	107
Ending debt	(8,000)	(7,500)	(7,000)	(6,300)	(5,600)	(4,600)
Net equity	$1,000	2,206	3,571	5,100	6,817	8,731
*Net value ÷ beg. equity***	*100.0%*	*220.6%*	*357.1%*	*510.0%*	*681.7%*	*873.1%*
Appreciation of net value over beginning equity	*0.0%*	*120.6%*	*257.1%*	*410.0%*	*581.7%*	*773.1%*
Internal rate of return	*0.0%*	*120.6%*	*89.0%*	*72.1%*	*61.6%*	*54.2%*
Annual sales growth		*8.0%*	*8.0%*	*8.0%*	*8.0%*	*8.0%*
Operating income/sales	*15.0%*	*15.0%*	*15.0%*	*15.0%*	*15.0%*	*15.0%*

* Earnings before interest and taxes
** Company was acquired for its gross value at the buyout date, that is, $9,000.

EXHIBIT 7-2
AVAILABILITY BASED ON ALTERNATIVE ADVANCE RATES AND DEFINITIONS OF INELIGIBLES

Description	Conservative Lender	Aggressive Lender
Gross accounts receivable	$10,000	10,000
Ineligible accounts:		
U.S. Government	(450)	
Customers with offset rights	(600)	
Customers with past due balances	(800)	
Foreign accounts without L/Cs	(350)	
Companies in bankruptcy	(125)	
Over 60 days (except above)	(1,500)	
Over 90 days (except above)		(850)
Borrowing base	$6,175	9,150
Advance rate	70.0%	85.0%
Availability	$4,323	7,778

EXHIBIT 7-3
ASSET-BASED LENDING FORMULAS

Asset	Range of Advance Rates	Comments
Accounts receivable	70% - 85% of eligible A/R	• Eligible A/R < 60 or 90 days • Some types of A/Cs may be excluded • Depends on quality of accounts and monitoring systems
Inventory	25% - 60% of market value	• Commodity inventory is most desirable • Fashion-oriented inventory is undesirable
Land and building	50% - 80% of appraised value	• Multipurpose attributes are beneficial • Environmental issues must be addressed
Equipment	50% - 80% of liquidation value	• Multipurpose attributes are beneficial • Special-purpose and difficult-to-move equipment is difficult to finance
Real estates leases	0% - 50% of market value	• Depends upon duration, transferability and other lease attributes • Multipurpose attributes are beneficial
Other intangible assets	0% - 75%	• Generally difficult to finance • Ability to finance depends upon liquidity and severability

EXHIBIT 7-4
LEVERME CORP.
DEVELOPING AN ACQUISITION PRICE
BASED ON AVAILABLE FINANCING

	FMV	Advance Rate	Avail. Credit	
AVAILABLE FINANCING				
New bank debt:				
Accounts receivable	$15,298	80%	$12,238	
Inventory	11,083	60%	6,650	
Fixed assets	16,000	50%	8,000	
Term loan			2,000	
New debt			28,888	(a)
Surplus cash			1,000	(b)
Unused trade credit			2,000	(c)
			$31,888	
PROJECTED DEBT SERVICE				
New bank debt:				
Interest @ 14%			$ 4,044	
Debt assumed:				
Principal, 8-year amortization			674	
Interest @ 10%			539	
			$5,257	(d)
PROJECTED FREE CASH FLOW				
Operating cash flow			$10,000	
Less:				
Debt service			(5,257)	(d)
Capital expenditures			(1,000)	
Working capital investment			(1,400)	
			$2,343	(e)
ACQUISITION PRICE				
Projected free cash flow (e) capitalized @ 25%			$ 9,373	
New debt			28,888	(a)
Surplus cash			1,000	(b)
Unused trade credit			2,000	(c)
			$41,261	

EXHIBIT 7-5
XYZ CORP.
EXAMPLES OF RETURNS REALIZABLE BY EMPLOYING ALTERNATIVE CAPITAL STRUCTURES

	At Buyout Date	Year 1	Year 2	Year 3	Year 4	Year 5
CAPITAL STRUCTURE # 1						
Bank debt	$8,000					
Common equity	1,000					
Total purchase price	$9,000					
Value @ 6 x EBIT		$9,720	10,500	11,340	12,246	13,224
Surplus cash		(14)	71	60	171	107
Ending debt		(7,500)	(7,000)	(6,300)	(5,600)	(4,600)
Net equity		$2,206	3,571	5,100	6,817	8,731
Repayment of debt		$500	500	700	700	1,000
Dividends		0	0	0	0	0
IRR on equity investment		120.6%	89.0%	72.1%	61.6%	54.2%
CAPITAL STRUCTURE # 2						
Bank debt	$4,000					
Common equity	5,000					
Total purchase price	$9,000					
Value @ 6 x EBIT		$9,720	10,500	11,340	12,246	13,224
Surplus cash		24	166	229	218	136
Ending debt		(3,250)	(2,500)	(1,750)	(1,000)	(250)
Net equity		$6,494	8,166	9,819	11,464	13,110
Repayment of debt		$750	750	750	750	750
Dividends		0	0	200	400	600
IRR on equity investment		29.9%	27.8%	26.1%	24.8%	23.8%
CAPITAL STRUCTURE # 3						
Bank debt	$1,000					
Common equity	8,000					
Total purchase price	$9,000					
Value @ 6 x EBIT		$9,720	10,500	11,340	12,246	13,224
Surplus cash		190	358	509	645	770
Ending debt		(800)	(600)	(400)	(200)	0
Net equity		$9,110	10,258	11,449	12,691	13,994
Repayment of debt		$ 200	200	200	200	200
Dividends		600	700	800	900	1,000
IRR on equity investment		21.4%	20.8%	20.4%	20.0%	19.7%

Note: Based on operating assumptions in Exhibit 7-1

EXHIBIT 7-6
XYZ CORP.
EXAMPLES OF IMPACT ON POTENTIAL PURCHASE PRICE THROUGH EMPLOYING ALTERNATIVE CAPITAL STRUCTURES

	At Buyout Date	Year 1	Year 2	Year 3	Year 4	Year 5
$8 MILLION DEBT FINANCING						
Bank debt	$ 8,000					
Common equity	2,862					
Total purchase price	$10,862					
Value @ 6 x EBIT		$9,720	10,500	11,340	12,246	13,224
Surplus cash		(14)	71	60	171	107
Ending debt		(7,500)	(7,000)	(6,300)	(5,600)	(4,600)
Net equity		$2,206	3,571	5,100	6,817	8,731
Repayment of debt		$ 500	500	700	700	1,000
Dividends		0	0	0	0	0
IRR on equity investment		-22.9%	11.7%	21.2%	24.2%	25.0%
SAME AS ABOVE, MODIFIED PRINCIPAL REPAYMENT						
Bank debt	$ 8,000					
Common equity	3,092					
Total purchase price	$11,092					
Value @ 6 x EBIT		$9,720	10,500	11,340	12,246	13,224
Surplus cash		286	236	121	46	82
Ending debt		(8,000)	(7,750)	(7,500)	(7,000)	(6,500)
Net equity		$2,006	2,986	3,961	5,292	6,806
Repayment of debt		$ 0	250	250	500	500
Dividends		200	350	500	300	300
IRR on equity investment		-28.6%	7.2%	18.6%	23.2%	25.0%
SAME AS ABOVE, BUT WITH $2 MILLION 15% PREFERRED STOCK						
Bank debt	$ 8,000					
Preferred stock	2,000					
Common equity	1,624					
Total purchase price	$11,624					
Value @ 6 x EBIT		$9,720	10,500	11,340	12,246	13,224
Surplus cash		186	186	271	196	232
Preferred stock		(2,000)	(2,000)	(2,000)	(2,000)	(2,000)
Ending debt		(8,000)	(7,750)	(7,500)	(7,000)	(6,500)
Net equity		($94)	936	2,111	3,442	4,956
Repayment of debt		$ 0	250	250	500	500
Preferred dividends		300	300	300	300	300
Dividends		0	0	0	0	0
IRR on equity investment		-105.8%	-24.1%	9.1%	20.7%	25.0%

Based on operating assumptions in Exhibit 7-1.
Purchase prices are designed to yield a 25% IRR on equity over a 5-year period.

CHAPTER 8
CLOSING THE TRANSACTION

INTRODUCTION

So you have found a company, negotiated the purchase price, conducted due diligence, structured the transaction, and put a financing structure in place. It will all come to naught unless you are able to consummate the transaction.This chapter focuses on the steps by which we bring it all together to complete a deal.

To complete a transaction, we must accomplish a number of milestones including:

- Completing the legal due diligence;
- Complying with regulatory requirements;
- Obtaining opinions from other professionals;
- Completing the purchase agreement;
- Obtaining approval and consent;
- Securing financing;
- Preparing for the transition; and
- Closing the transaction.

These are not sequential processes. They require the dogged persistence of each member of the acquisition team to ensure that there are no letups, and that they are properly concluded.

Remember that time is your enemy. With the passage of time, the odds increase that a competing buyer will offer a higher price; the company will be withdrawn from the market; financing sources will lose interest; business conditions will change; the seller will want more money; or worse, the seller will change his or her mind. Most buyers of privately held companies are intimately familiar with a term known as "seller's remorse." As sellers come closer to parting with their companies, they often begin to develop cold feet. They can't part with their baby. They don't know what they will do with the free time and windfall of money that they will soon have. They begin to seek out flaws in the buyers or the agreements and use them to rationalize why they shouldn't do the deals. Many deals have slipped away at the contract closing.

The key is to maintain a positive attitude towards the seller. Continue to sell him or her on the merits of your deal. Allow any acrimonious negotiations to occur between the professionals, rather than directly with the seller. Don't allow any grass to grow under your feet. Push your professionals not to get distracted or sidetracked. If the deal is going to require six weeks of time to complete, better that they be consecutive weeks rather than intermittent weeks where you and your people operate in fits and starts. Not only is it more efficient and less costly to operate that way, the probability of losing the deal altogether is reduced.

LEGAL DUE DILIGENCE

Legal due diligence is carried out by your attorneys. Its main objectives are to:

- Uncover potential liabilities;
- Ensure the seller's capacity to convey desired assets, liabilities, and other attributes of the business; and
- Ensure compliance with the law.

The main activities of a legal due diligence program include:

- Testing warranties in the purchase agreement;
- Ensuring the seller's compliance with the affirmative covenants of the purchase agreement and determining that negative covenants have not been violated;
- Establishing the transferability of assets, the assignability of executory contracts, and the assumability of liabilities;
- Reviewing key legal documents;
- Examining pending or threatened litigation;
- Identifying unasserted claims; and
- Ensuring compliance with regulatory matters.

The nature of regulatory requirements which are relevant are specific to the buyer and seller. Some of the general categories of regulations or regulatory authorities with jurisdiction over transactions include:

(1) Industry regulatory authorities which may have to approve a transaction. Examples include the Federal Reserve Board, the Civil Aeronautics Board, and the Interstate Commerce Commission.

(2) The Internal Revenue Service. In the event that a private ruling is required to approve the intended structure of a transaction.

(3) Foreign ownership limitations which either prohibit or require reporting of planned changes in ownership in certain industries such as telecommunications, newspapers, nuclear power plants, and defense contracting.

(4) Foreign restrictions against U.S. ownership of foreign assets.

(5) Antitrust guidelines requiring filings and clearance with the Federal Trade Commission or the Justice Department under the Hart-Scott-Rodino Act.

(6) SEC filings for transactions involving publicly held companies. The key filings are described in Exhibit 8-1.

(7) State and federal environmental laws may require the transfer of an environmental operating permit or a clean-up of a site contaminated by hazardous wastes.

(8) ERISA filings may be required if the pension plan will be modified or terminated.

(9) State laws and statutes involving Blue Sky regulations, bulk sales, and mergers and consolidations will have to be investigated and adhered to.

Some of these regulations consist of nothing more than notification and filing documents. Those requiring a response from a regulatory authority can result in delays which are difficult to manage.

REPORTS BY PROFESSIONALS

Many of the steps to concluding a transaction are very technical. The assistance of independent professionals is vital. Several formal documents and written opinions may be required. They may include:

- *A legal opinion* affirming that:
  - The acquisition agreement has been duly authorized, executed, and delivered;
  - The agreement is binding;
  - The agreement does not violate the seller's charter, bylaws, applicable federal or state laws, or other agreements of which counsel has knowledge;
  - Assets or contracts are assignable, saleable, or free from liens, and

- Other important legal issues have been addressed and resolved.

- *A tax opinion*, generally rendered by a tax attorney, opining on the proper tax treatment of certain difficult tax issues.

- *An acquisition audit* may be done by the buyer's accountants.

- *A comfort letter* may be provided by the auditors of the issuer of any securities which will be issued in connection with the transaction. This comfort letter is not an audit; rather, it contains negative assurances resulting from the application of "agreed-upon procedures."

- *A fairness opinion* may be issued to the seller's board of directors by its financial advisers stating that the transaction is fair from a financial point of view.

- A variety of other reports and documents may be issued by the buyer's or seller's professionals dealing with issues such as:
  - Asset appraisals;
  - Valuation opinions;
  - Attestation reports;
  - Solvency opinions;
  - Actuarial studies;
  - Environmental reports;
  - Financial projections; and
  - Pro forma financial statements.

CLOSING DOCUMENTS

Several of the documents and opinions may be explicitly referred to in the acquisition agreement as conditions preceding closing. The acquisition agreement will be the roadmap for how the purchase will to be completed, and will explicitly identify terms, obligations, and remedies. Unlike a letter of intent, an acquisition agreement is a legally binding document. It will document all of the legally enforceable provisions of the buyout. Normally, it is drafted by the buyer's attorney, unless the company is being sold in an auction. The party drafting the agreement has the advantage of being able to take the offensive in flavoring the agreement to meet its objectives. The buyer should never relinquish control of the all-important drafting process. An effort to save on legal fees at the front end by allowing the seller's attorneys to draft documents could result in an agreement which affords the buyer inadequate rights and protection. Remember that acquisition agreements are generally thick documents. Nobody knows the loopholes better than the party drafting it. To the degree possible, attempt to have the agreement reflect your authorship.

The major areas typically addressed in an acquisition agreement include:

- The identity of the parties;
- A description of the property being sold;
- Details of the transaction;
- Buyer and seller representations and warranties;
- The seller's conduct of business until closing;
- Conditions and events to precede closing;
- Termination provisions and penalties;
- Mechanics of closing, including required documents;
- Indemnification provisions;
- Covenants;
- Relationship of the parties and responsibility for events after the closing;
- A statement regarding applicable bulk sales laws or securities laws;
- Responsibility for transaction costs, such as brokers' compensation;
- Provisions relating to employee benefits; and
- Provisions for the resolution of disputes.

The acquisition agreement documents the results of negotiations. There may be considerable back and forth between the principals and their attorneys regarding the language and provisions of the acquisition agreement. The language of the agreement should be regarded seriously; it is the legal mechanism for protecting both parties and for providing remedies to problems and disputes. Depending on the situation, the acquisition agreement may be signed prior to closing or at the closing.

For a merger or the sale of stock or assets to be consummated, the parties to the agreement have to be authorized to bind their respective constituencies. Their authority is largely derived from state merger statutes and securities laws, as well as from the corporate charter and bylaws. Normally, the approval of a majority or a supermajority of shareholders is required for a merger to become effective. The process for soliciting the proxies of shareholders of publicly held companies is spelled out in federal securities regulations. Gaining the authorized consent of the buyer and seller in stock and asset purchases normally depends upon a separate set of laws and guidelines. They must be strictly adhered to for a transaction to become effective.

Financing commitments do not generally become effective until the transaction is closed. Because of the "chicken and egg" problem that the transaction is often contingent upon obtaining financing, a closing will often include the simultaneous execution of financing agreements and acquisition documents. Prior to the closing, lenders and other financing sources will conduct their due diligence, issue letters of commitment, and complete all of the documentation of the agreements. Loan documentation can be quite extensive. The "loan book" can be hundreds, or even thousands of pages long. The costs of investigating and documenting financing are borne by the buyer irrespective of whether or not the transaction is completed. The time and money spent completing the financing can rival or even exceed all other costs associated with completing the deal.

PREPARING FOR THE TRANSITION

As the myriad of activities moves forward to consummate the purchase or merger, you cannot lose sight of the end objective—to maximize the value of the acquired entity. If the acquisition process is not skillfully handled, there can be a substantial erosion of value before the transaction is completed—key employees can leave; customers may seek alternative suppliers; vendors may seek more onerous payment terms; and employee morale may dip to new lows, causing problems in productivity and quality control. These problems may also spread to the acquirer's operation—the acquirer's employees may fear job losses as a result of a consolidation; customers may fear that they will not be properly serviced because they will no longer be as important or because management is distracted by the purchase; vendors and creditors may fear that the buyer will be unable to meet financial commitments as a result of the mountain of acquisition debt; employees may devote significant time to feeding and feeding from the rumor mill. The common theme of all of these possibilities is fear—people fear the unknown, and often take action to limit its effect on them. The operations of the acquirer and the acquisition target can be severely debilitated as a result. Senior management may view the fears and concerns as "preposterous," but they are real to the people that possess them.

The key to mitigating these potential fears is to allow information and facts to take precedence over rumors and innuendo. A one-page memorandum to employees can prevent numerous unproductive hours of idle speculation. Proper communications with suppliers, creditors, and customers can nip their doubts in the bud. As soon news of the impending transaction becomes public, the public relations campaign to affected constituencies becomes vital to preserving value. Direct communication, written communications, and possibly, a task force or rumor control center can prevent unintended problems from arising.

A team comprised of representatives of the buyer and the target should be established to plan for the integration of the two entities. Middle management should be part of the process—they are often most knowledgeable about the intricate details of both entities, and may be most persuasive in arresting employee fears. Examples of areas that they should review should include:

- Organizational controls and responsibilities;
- Compatibility of financial reporting practices and systems;
- Opportunities to benefit from joint purchasing, production, and marketing capabilities;
- Redundant activities and resources;
- Compensation, benefits, and personnel policies; and
- Surplus assets.

The pre-merger planning process enables you to learn who the stars and the duds are in the target's organization. It also enables you to learn whether there will be a compatible union, and to gain a greater understanding of the prospective benefits of the merger. It also may convince you that the transaction should be terminated. It is better to learn that before the marriage, than to have to become involved in a costly divorce.

THE CLOSING

If we are able to surmount all of the obstacles that we have covered in this book, we are finally ready to proceed down the wedding aisle. The wedding ceremony, represented in this context by the closing, may last a few hours, or it can require days, or even weeks. The amount of time required depends upon how long it takes for the parties to satisfy the conditions to closing. The closing process may be divided into as many as three separate phases: the pre-closing process; the closing; and the resolution of post-closing matters.

The primary activities during the pre-closing process include:

- Distributing and reviewing all of the closing documents;
- Ascertaining that all conditions to closing have been satisfied or waived; and
- Resolving any open points affecting the transaction.

Many aspects of the closing may be accomplished or culminated in a pre-closing drill. In the pre closing, the parties convene and sign as many of the documents as possible in order to save time on the closing day. A checklist may be prepared which specifies the documents that must be delivered or signed at the closing.

A well-planned closing can be an anticlimactic process. The main components of the closing consist of the acquisition closing, the financial closing, and the payment of funds. This may occur at a single location, or in a deal involving multiple sources of financing, it may occur at several locations. Most of the work will be done by the attorneys representing each party. The buyer, seller, and financing sources will each need to have one or more authorized representatives. The accountants, financial advisers, and other experts will either be on hand, or must be readily available.

Examples of acquisition closing documents are likely to include:

- The acquisition agreement, if it has not already been signed;
- The articles or certificate of merger;
- Certificate(s) evidencing all of the securities being conveyed to the buyer;
- The bill of sale and assumption of liabilities agreement if the transaction is an asset purchase;
- Legal opinions;
- Comfort letters;
- Collateral documents;
- Adoption of corporate resolutions to consummate the transaction;
- Representations and warranties of officers;
- Escrow agreements;
- Employment contracts; and
- Letters of resignation by the seller's board of directors.

The financial closing generally occurs simultaneously to the acquisition closing, upon the delivery and execution of all the required documents for loan agreements and other financial instruments. Finally, financial consideration changes hands. This normally occurs via wire transfer, or through the delivery of a certified check, cashier's check, or bank check. Advanced planning is required to ensure the availability of the financial instrument at the time that it is required. For example, if the transaction is to be paid for through a wire transfer, then provisions generally must be made during a weekday that is not a legal holiday by no later than 3 P.M. Transactions have been known to be delayed or postponed because of an oversight in providing for payment of funds.

A merger may result in a truckload of documents. It may be impractical for each party to walk away from the closing with originals or copies of the needed documents. The post-closing process consists of arranging for the copying and distribution of all necessary documents to the proper parties, and cleaning up any unresolved matters. The clean-up phase may consist of completing activities that could not be completed by the closing, correcting documents, obtaining approvals and consents that were not available by the closing date, and dealing with miscellaneous other "nits and nats." Some of the activities may cause the most tedious audit or tax accounting tasks appear to be glamorous by way of comparison.

SUMMARY

After all this effort, we have a company to run, to add to the portfolio, to enhance our existing enterprise, or to serve as a springboard for what could eventually become a large financial empire. What may seem like a simple process, if envisioned as being nothing more than two moguls cutting a deal over lunch, is actually a very involved process, which can require numerous skilled professionals. Does the result justify the effort? That depends upon how well the transaction was conceived and executed on the front end, and on what the buyer does after he or she has the company. At the front end, we can make no guarantees. However, we can lessen our downside, and have a chance to get off to a running start by exercising diligence, prudence, and skill in:

- Identifying the acquisition target;
- Performing due diligence;
- Pricing the transaction;
- Structuring the transaction;
- Financing the transaction; and
- Closing the transaction.

Knowledge and mastery of most of the areas covered throughout this book will help you:

- Open the transaction to the best prospective buyers or sellers;
- Understand the buyer's or seller's negotiating alternatives;
- Structure the transaction to maximize your after tax proceeds; and
- Walk away from a completed deal, believing that you did the best job possible.

You can never know too much about mergers and acquisitions. To be effective, you need to understand the broad range of issues affecting the success of a company, as well as a number of issues specific to mergers and acquisitions. Exhibit 8-2 contains a list of readings which you will find useful to further your knowledge of mergers and acquisitions.

EXHIBIT 8-1
DOCUMENTS FILED WITH THE SEC IN CONNECTION WITH MERGERS & ACQUISITIONS

Documents filed with the Securities and Exchange Commission in connection with mergers & acquisitions may include:

- A *Registration Statement* if the buyer is publicly held and will be delivering securities;
- *Schedule 13D* within 10 days of acquiring 5% of a publicly held target;
- *Schedule 14D-1* if the buyer is launching a tender offer for at least 5% of a publicly held target;
- *Schedule 14D-9*, which contains management's solicitation or recommendation to shareholders in response to a tender offer;
- *Schedule 13E-3* in a going-private transaction; and
- *Schedule 13E-4* if the party making the tender offer will be issuing securities to the target company shareholders.

EXHIBIT 8-2
A LISTING OF MERGERS & ACQUISITIONS READINGS

The Acquisition/Divestiture Weekly Report.
The Acquisition Mart. (monthly newsletter)
Yakov Amihud, ed. *Leveraged Management Buyouts.*
Matthew Bender editorial Staff. *Valuation and Distribution of Marital Property.* (3 vols.)
Richard S. Bilber, ed. *The Arthur Young Management Guide to Mergers and Acquisitions.*
Gordon Bing. *Due Diligence Techniques and Analysis.*
William R. Bischoff and G. Douglas Puckett. *Guide to Buying and Selling a Business.*
Irving L. Blackman. *Valuing the Privately-Held Business.*
Arthur H. Borden. *Going Private.*
George Brode, Jr. *Tax Planning for Corporate Acquisitions.*
Ronald L. Brown, ed. *Expert Valuation of Professions: How Much are Medical and Law Licenses Worth Upon Divorce.*
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