Merger & Acquisition Focus

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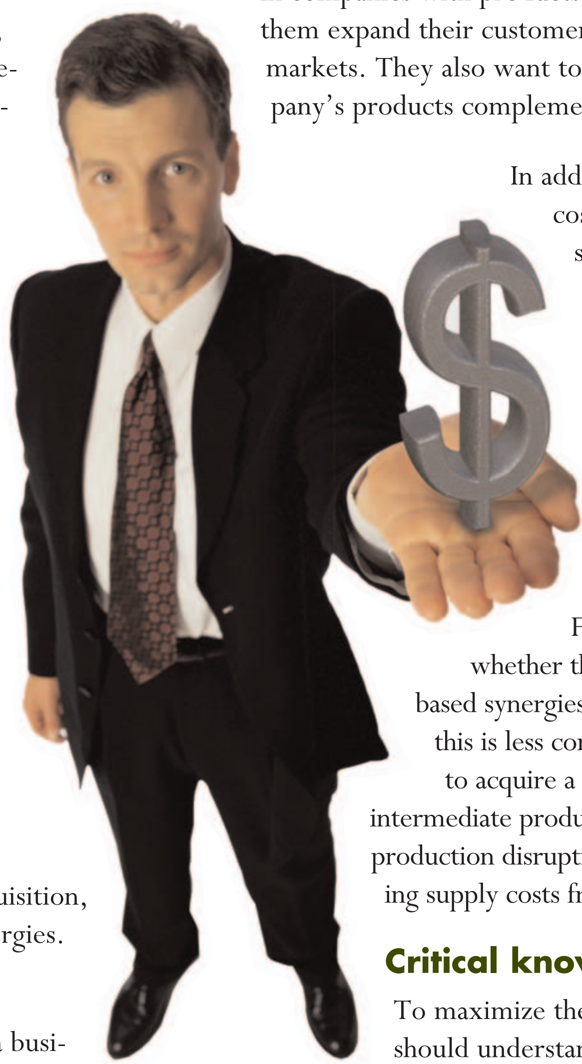
Selling your private business to a public company

In the world of acquisitions, buyers can generally be divided into one of two categories: financial buyers and strategic buyers. Financial buyers — often private equity funds — usually acquire businesses for the anticipated return on their investment.

Strategic buyers, which are frequently public companies, are often competitors or do business in a complementary industry niche. They seek revenue- and cost-based synergies, greater market share, acquisition of intellectual property, management strength, and, occasionally, the elimination of a competitor. For these reasons, strategic buyers typically pay more than financial buyers for the right acquisition.



Understandably, most private companies would rather attract strategic buyers. But how can you find public companies interested in acquiring your business and willing to offer the best price? You can start by understanding what public companies look for in an acquisition target.

Common synergies

Buyers must be convinced that the future benefits of owning your business exceed the acquisition price. They seek growth, but also need to know that extracting value from the deal won't be excessively costly or time-consuming.

When analyzing private companies for acquisition, buyers look for several revenue-based synergies. These include:

Geographic expansion. Buyers prefer a business with a geographic presence that doesn't overlap their existing reach. Expansion into new territory increases sales opportunities and limits the need for post-acquisition restructuring of sales forces.

Customer base expansion. Buyers look for companies with both broad and desirable customer bases. They weigh the likelihood that your customers will buy their existing products and their customers will buy yours. Buyers might also ask how easily they could integrate your customer data and marketing strategies into their own.

Product offering expansion. Buyers are interested in companies with products or technologies that will help them expand their customer bases and possibly enter new markets. They also want to make sure the acquired company's products complement their existing product lines.

In addition, public companies seek cost-based synergies when selecting acquisition targets. The most common of these is eliminating redundancy. Combining two companies' infrastructures — including labor forces, facilities and administration — frequently results in significant cost savings.

Finally, buyers will consider whether they can realize any supply-based synergies, or vertical integration. While this is less common, some buyers may want to acquire a business that makes a necessary intermediate product to minimize the risk of a production disruption or to prevent manufacturing supply costs from rising.

Critical knowledge

To maximize the value of your business, you should understand the strategic and financial needs of potential buyers. Merger and acquisition experts can perform this type of research for you, but you can also find out much about potential buyers from public filings, financial analyst reports and industry publications.

Intermediaries build bridges between buyers and sellers

Should you consider hiring a business intermediary to help arrange the sale of your company?

In some cases, you can do it yourself, particularly if you're selling to an "insider," such as an employee or relative, or an "outsider" you already know, like a friendly competitor. In these situations, your current financial and legal advisors may be able to handle the deal, and you can save the cost of hiring additional advisors.

In many cases, including those in which your current advisors have little or no transaction experience, intermediaries can offer important assistance. Selling a business generally requires a lot of time and effort. When you engage intermediaries, they do the work and allow you to concentrate on running your company.

Some prospective buyers are also more comfortable dealing with intermediaries — particularly in the initial stages of a deal. Private equity funds and companies interested in making an acquisition commonly contact intermediaries to find the best possible match. For this reason, any intermediary you consider hiring should boast strong relationships with potential buyers in your industry.

An intermediary can also resolve certain sticky situations. When dealing with a "friendly buyer," an intermediary can take a harder line in negotiations than a selling business owner might.

Finally, maintaining confidentiality is usually easier with an intermediary in the middle of the deal. Keeping a sale quiet until the ink has dried can prevent alienating customers, employees and other important stakeholders.

The information you collect can help you decide whether a public company has a need your company can meet. Once you've identified one or more potential buyers likely to be interested in your assets, you'll need to ask yourself some challenging questions such as:

- Are you really ready to sell your company?
- Is the timing right?
- Are your financial statements in order?
- Do your earnings look relatively strong?

If you answer all of these questions affirmatively, you may then want to determine the best way of contacting your potential buyer — either directly or through an intermediary. (See "Intermediaries build bridges between buyers and sellers" above.)

Prospective buyer interest

If public company buyers are interested in learning more about you, they may ask for a description of your business and for evidence of historical and projected financial performance.

But before you release any financial information to them, obtain a confidentiality letter. It stipulates that the prospective buyer will keep your disclosures confidential and will not use the information against you competitively.

Even with a confidentiality agreement, however, you risk providing a larger competitor with information it can use to its advantage if the deal falls through. Keep this in mind when considering your suitors.

A prospective buyer will probably want to meet with you and visit your facility. If the buyer maintains its interest following this visit and your release of financial information, it will then submit a preliminary and nonbinding letter of intent outlining the terms and conditions of a potential acquisition. Merger and acquisition experts and other financial advisors can help you evaluate this letter and negotiate further.

Window of opportunity

Even if you don't intend to sell your business anytime soon, it doesn't hurt to be prepared for the right offer. Typically, when a window of opportunity opens, it doesn't stay open for long. So you need to manage your company today to maximize its potential sale value tomorrow. That means making it as attractive as possible to public company buyers.

Moving on?

You have many liquidity options besides an outright sale

Business owners who want to retire, diversify their holdings or move on to other ventures may think their only liquidity option is to sell their companies. Not true. Given the richness of the U.S. capital markets today, even relatively small companies can realize liquidity in many ways other than an outright sale.

These include a variety of asset and financial restructuring strategies. Depending on an owner's personal and financial goals, as well as the size and financial health of the business, one or several may make more sense than a sale.

Your goals and resources

To determine the optimal exit strategy, owners need to identify their own goals. For example, do you want to transfer your business to one or more of your children or ensure that your company is managed by someone who will perpetuate your name? Or is management of your company less important than minimizing estate and gift taxes? Do you want to transfer ownership of your company to its managers or to all of its employees?

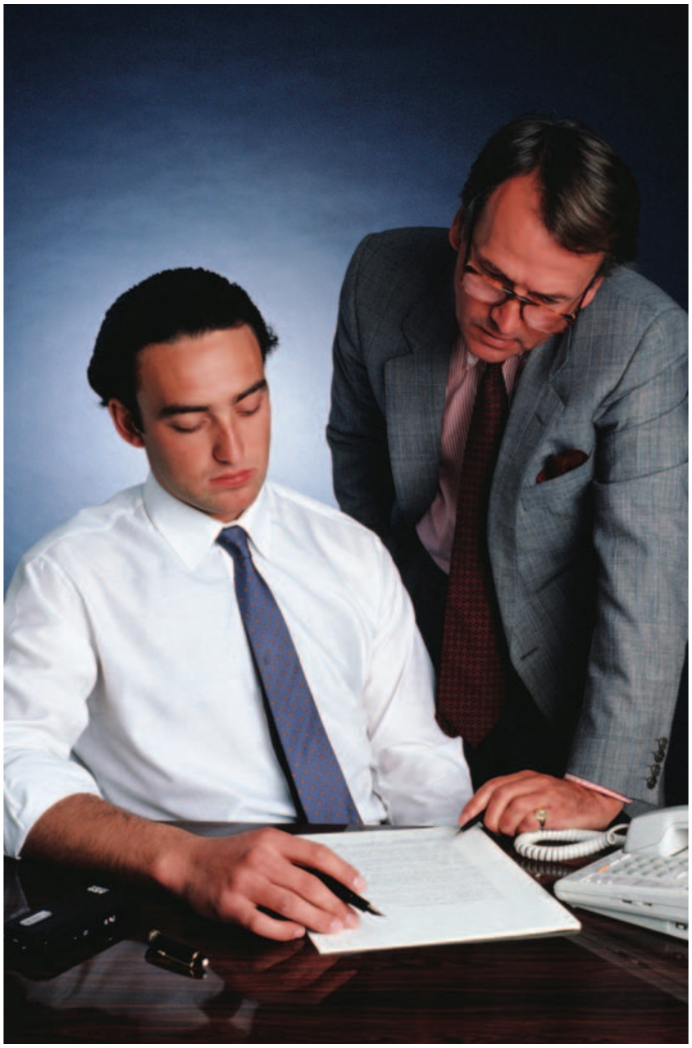
Owners also need to understand their company's strengths and limitations. One of your company's most important resources is its management team. If you haven't groomed one or more capable successors, many restructuring strategies won't be effective. In fact, without a succession plan, you may be better off selling your business.

When a sale isn't right

There are many reasons why a business owner might prefer a restructuring plan to a sale. If you've personally built your company from the ground up, you may want to see it continue as a legacy to your own hard work.

If you have partners or management willing and able to run the business, they may prefer that it not be sold. Or you may want to take only a portion of your money out of the business, leaving enough capital for it to grow and retaining partial control.

Timing can also be an issue. Owners seeking liquidity relatively quickly may have trouble finding a buyer when



they need one. Conversely, owners could be required to hand over the reins earlier than planned when an attractive offer comes their way.

Asset restructuring

Business restructuring strategies generally fall into one of two categories: asset and financial.

An asset restructuring is a transaction in which some or all of the firm's assets are liquidated or financed. While there are many derivative strategies, the most common asset restructuring strategies include:

- Asset spin-offs,
- Asset sales, whether in part or in total,

- Joint ventures and strategic alliances,
- Factoring, and
- Asset-based lending solutions.

Business owners wishing to avoid an outright sale can sell a portion of their businesses — for example, through a partial divestiture of a division. They can also investigate the more flexible option of the joint venture.

In a joint venture, two companies contribute one or more of their intangible and tangible assets in exchange for an interest in a newly organized entity. By combining assets, the two companies create synergies that allow them to profitably enter new markets or better serve existing customer bases.

This new business entity may provide the liquidity the exiting owner is seeking. On the other hand, many joint ventures don't provide initial cash to owners unless they are willing to forgo an ownership position in the new entity.

Financial restructuring

A financial (or stock) restructuring involves selling an equity ownership interest in the business to insiders (such as family members or management) or third parties (such as financial or strategic buyers), or paying an extraordinary dividend.

Common financial restructuring options include:

- One-time dividend or share repurchases,
- Sales of minority interests,
- Employee stock ownership plan (ESOP) loans,
- Initial public offerings (IPOs),
- Recapitalization, and
- Leveraged buyouts with employees or private equity funds.

The size of a company may prevent it from pursuing some financial restructuring options. For example, larger companies generating greater cash flow collateral are better able to finance the high cost of an IPO or obtain the funding to realize a leveraged buyout.

On the other hand, even small businesses can pursue ESOP and minority interest transactions. And the only constraint to executing a one-time dividend or share repurchase is finding a lender to provide the funds.

Good advice

Financial advisors can play an important role in helping you identify your personal and financial goals and assessing your company's resources. They can then suggest the best strategy for realizing value from your business, maximizing tax advantages and funding the next stage of your life.

Intangible assets, real value

Find alternatives to traditional financing collateral

In 2003's third quarter, Levi Strauss and Co. completed a refinancing in excess of $1 billion. While a significant event in the history of the apparel maker, it was also notable for the many other businesses seeking financing. That's because the deal was, in part, collateralized by Levi's trademarks and brand name.

Although investors and lenders traditionally accept tangible assets — inventory, equipment and real estate — as forms of collateral, many are increasingly willing to accept intangible assets as well.

Defining intangibles

More and more, intangible assets represent the largest or one of the largest value components for businesses. This is as true for intellectual-property-rich technology and biotechnology companies as it is for service, distribution and manufacturing businesses. These companies often boast intangible assets that materially affect their bottom lines, including loyal customer bases, respected brand names and strong management teams.

On a very basic level, intangible assets are those that can't be defined by their physical attributes, yet still contribute to the value of a company. More specifically, they can be classified in the following broad categories:

- Intellectual property (patents, copyrights and trade secrets),
- Technology (proprietary technology and technical know-how),

- Customer (prospect lists and customer relationships, including customer loyalty),
- Contracts (licenses, franchises, preferred suppliers and certificates of need),
- Data processing (information infrastructure, software and databases),
- Marketing (trademarks and trade and brand names), and
- Human capital (employee ingenuity, management experience, a well-trained work force, employment contracts and noncompete agreements).

Although these intangible assets are often recognized by company owners and management as valuable, balance sheets are less likely to reflect this value. While Financial Accounting Standards Board Statement No. 141 attempts to better value intangible assets during an acquisition, generally accepted accounting principles (GAAP) do a poor job of accounting for their fair value. GAAP records intangible assets that have been purchased at their original cost, rather than their current value.

Balance sheet values for internally generated intangible assets can be even more misleading; they reflect only the total of all expenses incurred to create the assets rather than their inherent value.

Because of these accounting practices, most of the value of many companies' intangible assets is left off their balance sheets. And without evidence of significant value, lenders are often unwilling to finance these companies' intangible assets.

Pinpointing value

Because balance sheets can misrepresent the value of intangible assets, companies wishing to use these assets as collateral for financing should obtain a professional assessment of their value.

To identify intangible assets with financial value, experts look for certain attributes, including: 1) a specific identification and recognizable description, 2) a legal existence and legal protection, 3) private ownership and legal transferability, and 4) tangible evidence of an asset's existence, such as a contract, governmental protection, document, listing, file, printout, registration statement or flow chart.

After confirming the existence of an intangible asset, valuation experts calculate its economic value to the owner — the amount by which it increases income or decreases costs. Generally, experts follow one of three approaches:

Market approach. Using this method, experts compare the intangible assets to similar assets for sale or used as collateral in the same or similar industries.

Cost approach. This values intangible assets by substitution, or what a company would pay to replace the asset with something comparably useful.

Income approach. With this approach, appraisers estimate the amount of income the asset is expected to produce in the future. They commonly use net income, net operating income, operating cash flow and net cash flow to calculate income. Experts also consider the asset's remaining useful life, so that income projections don't extend beyond that period.

Taking a combination approach

A proper valuation of intangible assets can help you gain credibility when seeking financing. Many investors and lenders, however, still rely on traditional valuations of intangible assets in their financing decisions and are less willing to accept "soft" assets as collateral.

Levi's strong brand was recognized by its investors as having significant value. But even the apparel giant used this intangible asset as collateral for only a portion of its financing, with the rest backed by tangible assets such as receivables and inventory. You may need to go the same route — relying on a combination of tangible and intangible assets to get the cash infusion you need.

Ask the Advisor

Q. There seems to be some controversy surrounding the use of EBITDA. What do I need to know about this measurement?

A. Many issues surround the exclusive and sometimes blind reliance on EBITDA (earnings before interest, taxes, depreciation and amortization). Although it's an easy financial parameter to monitor, using EBITDA to the exclusion of other, more traditional earnings measurements can lead to significant valuation errors.

In fact, neither generally accepted accounting principles nor the Securities and Exchange Commission (SEC) puts much faith in EBITDA. The SEC requires all public filings that include EBITDA figures to publish a disclaimer stating, in part, "EBITDA should not be considered as an alternative to net income or operating income, as an indication of our operating performance or as an alternative to operating cash flow as a measure of liquidity."

Investor Warren Buffett voices his skepticism of EBITDA even more eloquently in his 2000 Berkshire Hathaway shareholder letter: "References to EBITDA make us shudder. Does management think the tooth fairy pays for capital expenditures?"

EBITDA was first developed as a simple way to calculate a company's ability to service debt. It became a popular metric for determining company value during the 1980s' leveraged buyout phenomenon. Even today, it is widely applied to capital-intensive businesses with expensive fixed assets that can be depreciated over long periods of time, such as wireless communications and cable television companies.

EBITDA proponents argue that the metric prevents net income from being understated because of high depreciation or one-time infrastructure costs that otherwise mask high operating profits. This is especially true in cases where depreciation and amortization are greater relative to earnings.

But while sometimes useful, EBITDA determines only some of the cash flow companies generate. It ignores a company's need to reinvest, and managers who focus on EBITDA risk overlooking resource constraints, such as the need for future capital expenditures and working capital investments.

Managers making important operating and investment decisions — including pricing a proposed merger — cannot simply assume away such costs. Companies need to be monitored not simply for profitability, but also for how management maximizes scarce resources through efficient and effective investment decisions.

Other financial measurements do a better job of capturing shareholder value than EBITDA. Both internal rate of return and net present value capture the cash flow generated by the company, given the amount invested. These tools help analysts calculate profits, capital expenditures and working capital requirements while valuing the resulting net cash flow at a discount rate that reflects investment risk.

Of course, EBITDA isn't all bad. It can be helpful when used in conjunction with more traditional metrics. For example, when valuing a company, knowing the EBITDA multiple of similar transactions can tell you whether your negotiated price falls within a realistic range.