Merger & Acquisition Focus

April/May 2006

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Securing your base

Ensure employee support after acquiring a company

The work of buying a company may seem to lie in finding the right organization, negotiating a fair price, arranging financing and performing due diligence. But many acquirers find that winning the allegiance of new employees — as quickly as possible following a sale — is the real challenge of making an acquisition successful.

If you're acquiring a company — whether you expect to keep it as a standalone business or merge it into your own organization — you must devote time and effort to employees who experience the change. Otherwise, you risk jeopardizing the entire deal.

Easing employee uncertainty early

New owners and senior managers can cause great uncertainty and anxiety among rank and file employees. (See "Are you ready for some questions?", page 3.) After all, most of us are creatures of habit, and it can be unsettling when the organization where we spend our days and that provides our livelihood undergoes major change.

> *The style of your communications with new employees is as important as the content.*

Given the strength of corporate rumor mills, chances are that many employees will already know change is afoot when you officially announce your acquisition. Due diligence — which generally requires office and factory site visits and strangers asking questions — tips off many employees. To prevent rumors from taking on a life of their own, remember that they thrive in a vacuum. Good communication and leadership here are key.

Good leaders make good plans

Effective leaders differentiate themselves from mere managers in a fundamental way. Managers make decisions in an established framework, valuing efficiency and certainty.

Leaders, on the other hand, adapt to new circumstances and motivate others to accept necessary change. Dealing with the change of a new corporate owner requires a good leader skilled in communication, not just a good manager.

As soon as possible, put together a strategic plan for running the business. This should include the goals of and rationale behind the plan, key deliverables, a timeline for completing them and a list of the executives responsible for achieving the objectives.

Release this plan to employees and report on its progress periodically. The organization's goals and strategy won't be important to employees unless they feel these things are important to you, so keeping your workforce updated on successes and new developments is paramount.

Be visible

To be a good leader, energize and rally employees to your side and make it a point to be visible, meeting face-to-face, if possible. This has several advantages. First, it ensures you reach the people you need to reach. Second, it gives you the opportunity to learn what's really going on in the company — information you may not hear from the people who directly report to you. Finally, your presence can have great symbolic value.

There are many ways to be visible. Start by introducing yourself in meetings, memos and newsletters. Also consider holding "town meetings" with question and answer sessions, informal meals with a cross section of employees and spot visits to departments and remote company locations.

Communication is key

The style of your communications with new employees is as important as the content; make sure your corporate communications are clear, concise, frank and informal (but not too informal) in tone. You should also be inspirational without sounding overbearing or preachy. Employees like being part of a successful company, but resent being talked down to or asked to accomplish more than is feasible.

Don't sugarcoat or bury bad news. You'll lose credibility, and chances are that many employees will already have heard about negative events, such as layoffs, through the grapevine. Finally, be sure you're as good a listener as a speaker.

Make loyalty and enthusiasm an asset

The loyalty and enthusiasm of your workforce can be a tremendous asset; their absence can be a liability that retards progress. Make new employees a priority when you first buy a company and continue to nurture these relationships as you go forward. If you do, you'll be well on your way to a successful acquisition.

Are you ready for some questions?

The sale of a company to a new owner can generate tremendous anxiety — and questions — among employees. To allay concerns, be prepared to answer the following:

- Will there be layoffs?
- If I am laid off, how soon will it happen and how much severance will I receive?
- Who else will be laid off?
- If I'm not laid off, will I keep my current position, wages and benefits?
- Who are the company's new executives and managers?
- How will our company's business change?

These and other employee questions may not be answerable for some time, but that won't stop the rumor mill from supplying answers right away. To reduce uncertainty and help ensure productivity, make it a priority to find answers and communicate them as soon as possible.

How private equity can help you grow

Owners of small and midsize companies may be familiar with the role private equity firms can play when they're ready to retire or seek liquidity. They may be less aware of how private equity firms can partner with them to make acquisitions, helping grow their businesses.

The world of private equity

Private equity firms raise money from pension funds and other large investors that they pool to buy private companies. The firms generally resell the private companies within three to seven years for a profit.

Private equity firms leverage the money they receive from investors by borrowing large amounts. When they buy a company, for example, only 20% of the purchase price might come from the firm's investment fund, with the other 80% supplied by banks and specialized lenders. Ultimately, the debt portion of the total purchase price is determined by the amount of assets in the acquired

company that may be collateralized against the loan. The equity portion comprises the remainder of the total price.

Some private equity firms are relatively passive owners of the companies they buy; they rely on existing key management to grow the company and identify potential buyers for a future sale. Other firms add value to acquired companies by reinvesting in them and helping them make acquisitions. The latter can make ideal partners for private companies that seek growth opportunities.

Profitable enterprise

Say, for example, you've built a profitable business with good growth prospects and low debt. You're not yet ready to retire, but you'd like to convert some of your ownership to a more diversified and liquid form. You may enjoy managing your business but would welcome financial and managerial support to take it to the next level.

From the vantage point of many private equity firms, your company would be an attractive partner. An interested private equity firm might already own a business that would benefit — from, for example, sales and cost synergies — if it were to be merged with yours.

A private equity firm willing to partner with you is likely to be knowledgeable about your industry and capable of finding acquisition targets within it. Generally these firms recognize the value of your continued involvement in the business, and you benefit from the financial and operating experience of the private equity firm's executives.

Limited partnership

If you find a private equity firm that shares your objectives and values, the firm initiates the partnership through a transaction called a "leveraged recapitalization." In a leveraged recap, you agree on a value for your company and sell a majority stake, say, 75%, to the firm. A private equity firm, however, may take as little as one-third ownership.

To partially pay for the purchase, the firm borrows from lenders (usually a combination of senior and subordinated debt), using your company's balance sheet to secure the loans. The firm supplies the remainder of the purchase price from its investor fund and may ask you to reinvest a small portion of the sale proceeds in the company.

In some cases, the private equity firm finds a suitable acquisition candidate for your company, acquires the new business using the same leveraged recap method and merges it with your company. Other acquisitions may follow using the same process.

Your role in your recapitalized company and in the merged organization depends on the agreement you've made with your private equity partner. You may wish to remain as CEO, with one of the firm's executives acting as chairman of the board. Or the firm might insist on bringing in an industry veteran as CEO and name you as a director on the board.

> ***To ensure your partnership with a private equity firm is successful, speak to other owners who have partnered with the firm.***

Because most private equity investments have a finite life, your company or combined business will be divested eventually. It may be sold to another private equity firm, or to a strategic acquirer such as one of your competitors. Your private equity firm may even decide to do an initial public offering.

With an increased business value, you're likely to realize a higher price for your minority shares than your majority shares originally sold for. But your involvement in the business most likely will end at this point.

Make it work

To ensure your partnership with a private equity firm is successful, speak to other owners who have partnered with the firm to discuss their experience and enlist the help of experienced M&A advisors.

Also, remember that being acquired by a private equity firm is not a relationship for life: The firm will likely sell your business in a few years. Make sure you're comfortable with this eventuality and are ready to relinquish control of your company.

Case study

Timeline of a successful M&A transaction

The sale or purchase of every private business is a unique event, yet some elements are common to almost all M&A transactions. The sale of fictional Faulkner Fine Furniture Co., a regional manufacturer of designer wooden furniture, to a larger manufacturer, Gray Ellis Furnishings, illustrates the key stages.

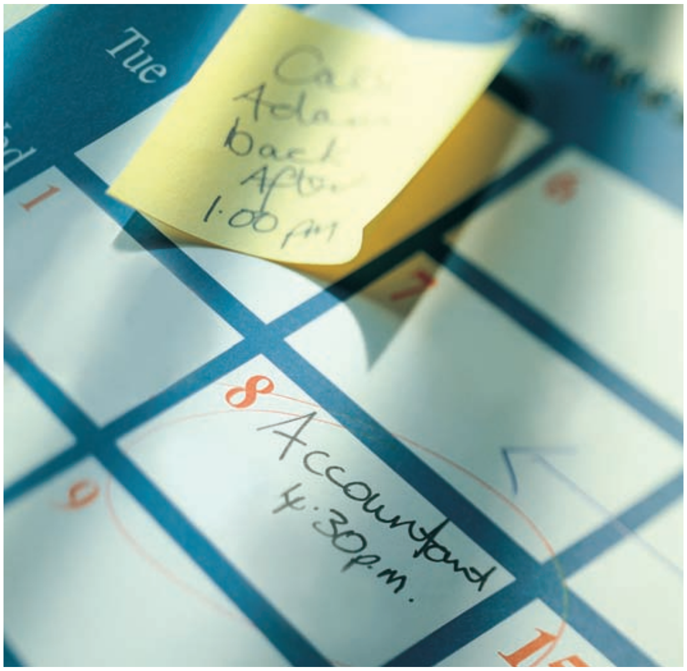
Good preparation

Chuck Faulkner began preparing to sell his business by meeting with an M&A advisor in early 2002. His advisor's firm had expertise in the furniture industry, with several successful related deals under its belt.

Chuck's advisor told him that prospective buyers would require at least three years of solid financial results, so Chuck began to improve his company's cash flow by boosting sales, eliminating unnecessary expenses and paying down bank debt. He also:

- Sold unproductive equipment,
- Made sure his warehouse and two plants were repainted and landscaped,
- Resolved a small environmental issue and two potential employee lawsuits, and
- Reviewed accounting policies to ensure costs were being capitalized rather than too aggressively expensed.

In late 2004, Chuck formally hired his advisor, who recommended a targeted selling price of $10 million, which



was five times Faulkner's expected 2004 earnings before interest, taxes, depreciation and amortization.

On the market

During January 2005, Chuck's advisor prepared an offering memorandum to circulate to prospective buyers. The memorandum described the business, complete with five years of financials readjusted, or "normalized," to reflect operating and accounting methods a likely buyer would use.

At the same time, the advisor drew up a list of potential bidders and their intermediaries, including business brokers and investment bankers, competitors, private equity funds, and executives known to be looking for an acquisition target. Over this period, Chuck was careful to keep his company's senior management, directors, lawyer, accountant and banker informed of the process.

In early February, the advisor circulated the memorandum to the list of prospects. Each recipient was required to sign a confidentiality statement as a condition of receiving it. This document invited recipients to submit a written indication of interest by the end of the month. Prospective bidders were asked to estimate the amount of their offer and explain their financing, staffing, due diligence and closing plans.

Arriving at a buyer

By March 1, Faulkner had received five indications of interest. Of these prospective buyers, two competitors and two private equity firms were invited to meet with Chuck, his senior managers and his advisor. During these meetings, Chuck and his executives presented the key points outlined in the offering memorandum, asked questions raised by each prospect's indication of interest and answered the buyers' questions about Faulkner.

From the four teams that made presentations, Chuck chose three — two competitors and one private equity firm — to submit letters of intent by April 14. He requested that bidders state their best price and document how the purchase would be financed and structured. From the start, Chuck had indicated he'd accept only a stock deal, not an asset sale.

After reviewing the letters of intent and completing a week of final negotiations with two of the three bidders, Chuck notified one of Faulkner's competitors, Gray Ellis Furnishings, that it had the winning bid and could begin due diligence. The due diligence process took only a month, partly because Faulkner's financial records were well organized and its references — from suppliers, distributors, commercial bankers and others — were highly complimentary.

To be sure, the buyer was thorough. Its M&A advisor, legal counsel, accounting firm, insurance consultant, human resources director and even a private investigator scrutinized every aspect of Faulkner's business and its management team. By mid-May, the process was completed and Gray Ellis communicated its approval to Chuck.

Closing the deal

After a week of final work by the companies' attorneys to fine-tune the details of the purchase and sale agreement, the document was signed on May 22. The proceeds were wired to Chuck's account the same day.

The selling process had taken ten months from start to finish. Chuck knew he could have pushed to finish it sooner, but the final price justified his patience. In addition to price, the deciding factor in choosing Gray Ellis was the company's commitment to retain most of Faulkner's senior managers and provide generous severance to those who would be replaced or have their positions eliminated.

Gray Ellis's acquisition strategy was primarily based on growth assumptions, not cost-reduction synergies. Chuck believed that his employees would benefit from being part of the larger company.

Secrets of success

Looking back on the process, Chuck thought it had gone smoothly. He attributed this to four factors:

1. His company was profitable and growing,
2. He'd prepared for the transaction well before beginning the process,
3. His advisor was experienced in selling his type of business, and
4. Chuck had realistic expectations about the value of his company.

Not every transaction goes as smoothly as this one, but owners interested in selling their company can learn from what went right with the sale of Faulkner. Also be aware that actual business sale timelines can vary significantly based on the industry, company size, transaction size, number of eligible buyers and economic trends.

Ask the Advisor

Q. Is it possible to sell my C corporation without paying current taxes?

A. If the IRS considers your transaction a "reorganization," you may qualify for a tax-deferred sale. This type of sale can be very advantageous to both you and the corporation that buys your business.

Tax-deferred reorganizations (TDRs) are permitted under Section 368 of the Internal Revenue Code. The code allows you to structure your reorganization in a variety of ways, but a common reorganization method — a stock-for-stock TDR — illustrates the advantages of this process.

With a stock-for-stock TDR, you transfer at least 80% of the stock in your business to another corporation, receiving the buyer's stock in exchange. To the extent no cash is received during the transaction, no tax is due on this exchange and your new stock assumes the same tax cost and holding period of the old.

As long as you hold the new stock for more than a year, you pay long-term capital gains tax when you eventually sell (assuming you sell for a gain). If you sell the stock before the holding period has lapsed, however, your gain is considered ordinary income and is taxed at your higher, ordinary income tax rate.

The longer you hold the new stock, the longer you can defer taxes. And if your buyer is a larger, publicly traded company, the benefits can be significant: You've exchanged an undiversified, relatively illiquid investment — your former business — for a more diversified investment that can be more easily sold.

A stock-for-stock TDR benefits buyers, too. If the company acquiring yours has a net operating loss carryover, it may be able to use that carryover to lower its taxes. This type of transaction can also be ideal when a buyer is looking for an alternative to debt financing. For example, a buyer may prefer a stock transaction if it feels its stock is highly priced — and is thus good "currency" — or if its existing level of debt makes additional borrowing difficult.

For a reorganization to be considered tax-deferred, the IRS requires three things:

1. The buyer must have a business purpose for the merger other than saving taxes, such as expanding sales, reducing costs or diversifying.
2. The buyer must continue operating the acquired company, or continue to use a significant amount of its assets.
3. A significant portion of the seller's "consideration," or sale proceeds, must be in the form of the buyer's stock.

Meeting this third requirement can be complicated, because TDR transactions may involve cash or other property, in addition to the buyer's stock. Nonstock consideration is referred to as "boot." How much of the consideration can be boot — as opposed to the buyer's stock — and whether the boot is taxed as ordinary income or long-term capital gains can become subject to IRS scrutiny.

Before you consider a TDR, keep in mind several caveats. Once you own your buyer's stock, you won't be able to exert much control, as you did with the business you sold. And, if you sell your new stock prematurely, you risk losing the tax benefit. You also need to be careful about following strict IRS guidelines to qualify for the lower tax rate.