Merger & Acquisition Focus

June/July 2008

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The journey ahead

MAP OUT SUCCESSION, RETIREMENT AND ESTATE PLANS *BEFORE* YOU EXIT YOUR BUSINESS

You've worked for many years to build a successful company, and now you're starting to think about retirement. To ensure a smooth exit from the workplace, establish your retirement and estate plans now — well before you're ready to sell or transfer your business.

Early planning will help ensure that you adequately provide for your retirement needs and the financial security of your heirs. It will also foster the continued success of your company and its employees.

Assess where you are

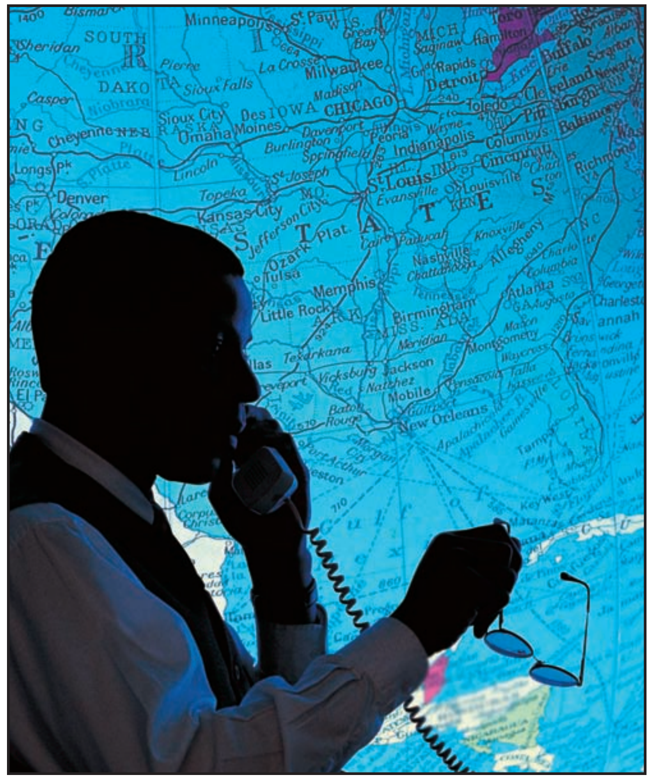
Before determining where you want to be when you're ready to retire, assess where you — and your business — are financially today. It sounds like a large undertaking, but you can start by preparing a detailed financial analysis of your business with the help of a valuation professional. This expert will review historical data to determine your company's current value.

You will also need to examine all contracts and agreements to make sure your business is transferable. Transfer restrictions, such as professional license restrictions, franchise agreements, lending agreements, shareholder agreements or other types of contracts, can slow down the process significantly.

A high concentration in one asset, such as your business, could result in a precarious financial situation if the asset were to decline significantly in value.

Plan for success(ion)

Next, develop a succession plan that outlines how your business will be sold or transferred. If you have business partners, they will most likely be able to buy your ownership interests according to the terms of your company's shareholder agreement or other agreements established among you.



Or you might choose to groom one of your children to eventually take the helm. To ensure a smooth transition, however, your successor should assume significant management duties and at least partial ownership before you retire.

If you have no qualified family members or partners, consider selling the business to a key employee or group of employees. Employee buyers may have several financing options, including private equity partners, bank loans and Employee Stock Ownership Plans (ESOPs). ESOPs are fairly complex structures and will require valuation and tax planning — as well as employees who are committed to the company for the long haul.

If none of these succession options seem viable (or attractive), see "2 more exit strategies" on page 3.

Think retirement

The first considerations for retirement planning are your health, lifestyle and any financial obligations. You will use these to determine your required revenue stream.

In addition to qualifying for Social Security benefits, you likely have retirement accounts such as IRAs or 401(k), Keogh, or Simplified Employee Pension (SEP) plans. When tapping these accounts, be sure to avoid actions that could have negative tax consequences. Also bear in mind that minimum distribution rules govern many tax-deferred retirement accounts. Traditional IRAs, for example, compel you to begin taking distributions after age 70½ or face significant penalties.

Also, certain corporate entity formations may provide options for additional distributions and more favorable tax treatments. Consider changing your corporate structure and placing assets where they facilitate the most cost-efficient succession. This is where a professional investment advisor is essential.

Even if you've managed your own investments thus far, a financial planning expert and tax advisor can help determine whether your retirement funds are likely to support your plans.

These experts also help you ensure your assets are well diversified in a way that doesn't put your nest egg at unnecessary risk. A high concentration in one asset, such as your business, could result in a precarious financial situation if the asset were to decline significantly in value.

You might also want to consider staying with your company after the sale — perhaps as a paid consultant or salaried employee. Doing so may provide extra income that allows you to put off tapping your retirement accounts and investments, and you'll be able to continue contributing to your tax-advantaged retirement plans. But working part-time also has tax consequences, so be sure to discuss any such plans with your financial advisor.

Protect your estate

Just as important as succession and retirement plans is an estate plan. If you haven't already, write a will and appoint an executor to oversee the distribution of your assets when you die.

2 more exit strategies

What's a retiring business owner to do when there are no family members, partners or key employees to take over? Consider these other two major exit strategies:

1. **Selling to an outsider.** You may be able to sell to one of your competitors. Similar companies, or those in related lines of business, might view your company as a good expansion vehicle. Evaluate whether your business would generate more proceeds if sold intact or broken down by segments or product lines.

2. **Liquidating or divesting your assets.** This might be your best option if you have equipment or real estate, or particularly valuable profit centers, and it seems unlikely you'll be able to sell the business outright because of weak financials or a changing marketplace.

Trusts can help you avoid the costs and inconvenience of probate. Trusts may also protect assets from creditors, provide privacy and come with professional investment management services. Your circumstances — including your assets' estimated value, their allocation and your beneficiaries — will help determine the structure and tax implications of your ideal trust.

Trusts can also be designed with special provisions. You might, for example, want to:

- ❖ Manage wealth through fiduciaries for living family members,
- ❖ Ensure the support of a child with special needs,
- ❖ Make a gift to a favorite charity, or
- ❖ Create tax-friendly structures.

If you decide to make a trust a component of your estate plan, be sure to appoint a trustee who's a neutral party you can trust.

Pick your partners

Planning your exit strategy, retirement revenue and estate distribution isn't a simple task. At this critical juncture of your life, legal and financial professionals are essential partners. ■

New accounting rules may affect your M&A deal

A bottle of aspirin won't cure the major headache some M&A participants face accommodating new accounting rules. Issued by the Financial Accounting Standards Board (FASB), the rules could require more extensive valuation work, increase costs and lengthen the negotiation process. They require business buyers to scrutinize certain provisions in some transactions and may even call for the termination of marginal deals.

Holding you to new standards

As intangible assets such as goodwill associated with intellectual property become more important, regulators have recognized the need for more appropriate accounting standards. Statement of Financial Accounting Standards No. 141 (SFAS 141), issued in 2001, mandated that all business combinations be accounted for as a purchase by one company of another, rather than as a merger of equals. It also required that all assets and liabilities acquired be recorded at their fair market values.

In late 2007, FASB issued two new standards. One, Statement No. 141R, *Business Combinations*, revised the accounting for business combinations. The other, Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*, changed the accounting and reporting for minority interests in subsidiaries. This second standard stated that all entities must report noncontrolling or minority interests in subsidiaries in the same way — as equity — in the consolidated financial statements.

SFAS 141(R) and 160 are products of a joint initiative between FASB and the International Accounting Standards Board — the first in what is expected to be a series of standards issued jointly for the global business community. Both standards, which are set to take effect in fiscal year 2009 for calendar year end companies, require more recognition and measurement of acquired assets and liabilities at fair value, as well as greater disclosure on financial statements.

Structural shifts

One of the biggest adjustments you'll need to make in the wake of SAS 141(R) and 160 is in how you report expenses — particularly transaction fees. The rules require that you expense transaction fees related to an acquisition as they are incurred and included on your income statement, rather than capitalizing and amortizing them over time on your balance sheet.

Financing costs will continue to be capitalized. But fees related to bankers, attorneys, accountants and other advisors must be expensed in the period they are incurred — even if you've yet to publicly announce a prospective acquisition.

Also be aware of how the new rules affect contingencies. In the past, liabilities didn't have to be recorded until their dollar amount was known. The value of uncertain liabilities (such as future warranty payouts) now must be estimated at the time of acquisition. And you need to have the estimates revalued on a quarterly basis, adding any changes to your company's income statement.

Fortunately, you aren't required to estimate and report a contingency if it's not based on a contractual issue and isn't likely to significantly affect the company. This might include, for example, assets and liabilities from a potential legal claim, tax dispute or environmental hazard.

Finally, the valuation process now includes an acquisition's contingent considerations. The value of earnouts or carveouts, for instance, generally are contingent on the future profitability of the acquired business. According to the new rule, the fair value of the contract must be recognized at the acquisition date, but not recorded on the buyer's balance sheet until the payout is made. The difference between the estimated earnout and the actual payout must be reported as a loss or gain.

Business as you know it (or don't)

How will the new rules affect the M&A transaction process? You may need to rearrange some deal activities to avoid signaling to the market that a major transaction is in the works. This is a particular concern with large transactions.

By all means, during due diligence probe significant issues such as financial statement irregularities, regulatory matters, potential fraud, pending legal claims or the possible departure of key employees. But consider putting off less critical matters until later, when you'll be freer to scrutinize the issues outlined in your purchase agreement.

Also be ready to provide more upfront recognition and measurement of deal contingencies, such as plans to eliminate a product line or close a facility. Other aspects of M&A transactions that the new FASB rules may alter include:

Ongoing research and development (R&D). Buyers that acquire companies with in-process R&D can no longer immediately write them off. Such write-offs will be targets of greater scrutiny — especially in industries such as pharmaceuticals and technology, where these expenses make up a significant portion of the business.

The measurement date. The valuation measurement date is now the closing date of the transaction, as opposed to the date the agreement was entered into. If a merger is delayed for regulatory or other reasons, the difference in value between these two dates can be significant.

Step acquisitions. The accounting for step acquisitions, in which a company buys pieces of another company at different times, has also changed. Previously, companies recorded the fair value of only the most recently purchased piece. Under the new rules, each time a piece of the acquired company is purchased, all of the assets acquired to that point must be revalued.

What's ahead

FASB's new rules certainly won't prevent good deals from getting done, but they can make them more complicated. So it's wise to consider the potential impact of SFAS 141(R) and 160 when evaluating your expansion strategies. ■

Focus on the future

ANTICIPATING ACQUISITION SUCCESS WITH STRATEGIC DUE DILIGENCE

Savvy business buyers know that due diligence is essential for assessing the value of a potential acquisition. But sometimes the due diligence process is conducted too quickly — or too narrowly — and focuses on only a company's historical performance, rather than on how it's likely to perform once the deal is complete. For an advance look at your acquisition's potential success or failure, consider conducting *strategic* due diligence.

Target: Realism

Legal, financial and operational due diligence help determine value, uncover risks and establish a fair purchase price. But, even when buyers conduct what they believe to be thorough due diligence, transactions fail because the companies integrate badly or the deal doesn't live up to high expectations.

Strategic due diligence specifically addresses whether a deal is realistic and not simply overly optimistic on the buyer's part. It should be considered additional to the usual screening processes.

A 360-degree view

Strategic due diligence evaluates a deal and explores its rationale from its various angles. These include the company's:

Market. The success of your merger will depend largely on the health of the potential target's market. For example, is the market expected to continue growing at its current rate or is it maturing? And how will technological advancements affect market activity?

During your market investigation, determine current market sizes and their competitive characteristics and drivers. Then forecast growth in the segments relevant to the target. For an unbiased perspective, talk with customers, competitors, industry observers, suppliers and regulators, rather than relying on data from the target company's management.

Customers. If your target has an up-to-date customer database, conduct a five-year study. Identify major customers, analyze their key purchase criteria and determine whether their business is based on personal relationships with key personnel. Also consider negative indicators, such as service or product complaints, low loyalty rates, or delinquent payments. This data is essential to determining how well the company is currently meeting its customers' needs — and how well it will sustain growth and revenues in the future.

Competitive positioning. Ask whether your target company has successfully differentiated itself from others in the market. Does it have adequate resources and capabilities to stave off the competition? What is the competitive edge of new market entrants? What type of consolidation or divesting activity has recently occurred in the industry? Sometimes sellers' motivations stem from impending competitive threats that won't be obvious from your due diligence.

Look for managers who can adapt to change and are capable of implementing decisions quickly.

Management. Ideal market conditions and a differentiated competitive position will be all but lost on an ineffective management team. Assess the capabilities of individuals and groups to determine what — and who — is working.

It's particularly important to ask whether the current management team will be able to deliver on the deal's anticipated value. Regular management due diligence, such as background checks, is a necessity, but consider conducting competency-based interviews, too. Look for managers who can adapt to change and are capable of implementing decisions quickly. These characteristics will be crucial during the integration period.

Encouraging confidence

You will need to invest resources — both time and money — in the strategic due diligence process. But you'll also reap significant returns. In addition to contributing to an estimate of the company's market value, your findings can help you articulate your strategic rationale to your investors, lenders, board, employees and other stakeholders.

Knowing you've performed such extensive research — and considered not just the past, but also the future — stakeholders are likely to feel more confident about the long-term benefits of the transaction. Strategic due diligence also paves the way for a smoother, more successful integration. ■

Ask the Advisor

Q: What is a fairness opinion and do I need one?

A. A fairness opinion is a formal review, typically prepared by a third-party entity (an investment banker or business appraiser) of an M&A deal's price, terms and other financial characteristics. It assesses whether a transaction is fair to shareholders and others involved by comparing the deal with similar ones and evaluating any meaningful differences.

Fairness opinions generally analyze the underlying assumptions of the deal, as well as industry and economic trends. They also determine a range of prices that might be considered fair, impartial and just for all parties.

Impartial view

Fairness opinions are often used when an M&A transaction isn't conducted at arm's length — by two independent parties — or at market price, such as an insider-led financing or a management buyout. Other transactions for which a fairness opinion may be useful include:

- Corporate divestitures,
- Leveraged buyouts,
- Recapitalizations and restructurings,
- Employee Stock Ownership Plans (ESOPs),
- Exchange offers or minority buyouts,
- Stock purchase and repurchase agreements,
- Court-appointed valuations in the event of a hostile takeover,
- Liquidations,
- Bankruptcy reorganizations, and
- Dissenting shareholder disputes.

Sellers typically request a fairness opinion when an acquirer first expresses interest. This allows time for other prospective buyers to make competing offers if the original bid is at or below the low end of the fairness opinion's price range.

Not a foolproof tool

Both buyers and sellers use fairness opinions to shield themselves from potential lawsuits by shareholders who might claim they were shortchanged by the transaction. But these opinions don't guarantee litigation protection, nor do they necessarily reflect the full value of a proposed deal.

Fairness opinions, for example, don't address a deal's viability from strategic, operational, management, timing or legal standpoints. They also don't offer judgments on the financial projections the buyer relies on for its bid price. Additionally, fairness opinions help sellers evaluate whether an offer is adequate but don't tell buyers whether they should make the acquisition.

Potential conflicts

To get the most out of a fairness opinion, watch for conflicts of interest. Ensure that the professional who prepares the opinion is impartial and objective.

Conflicts of interest are typically signaled by financial incentives. For example, buyers shouldn't seek a fairness opinion from an investment banker who will receive a percentage of the transaction if it's approved. It's inadvisable for sellers to engage a financial advisor who runs a private equity fund that could potentially bid on the company. Ultimately, to allow the expert to assess the deal and ensure that there are no conflicts of interest at play, both parties should agree to an impartial professional early in the process.

Some assurance

A fairness opinion isn't a substitute for thorough due diligence, and it won't guarantee that a deal is a smart business move or will survive legal challenges by shareholders. But an impartial opinion can provide you with some assurance that stakeholders are being treated openly and fairly. ■