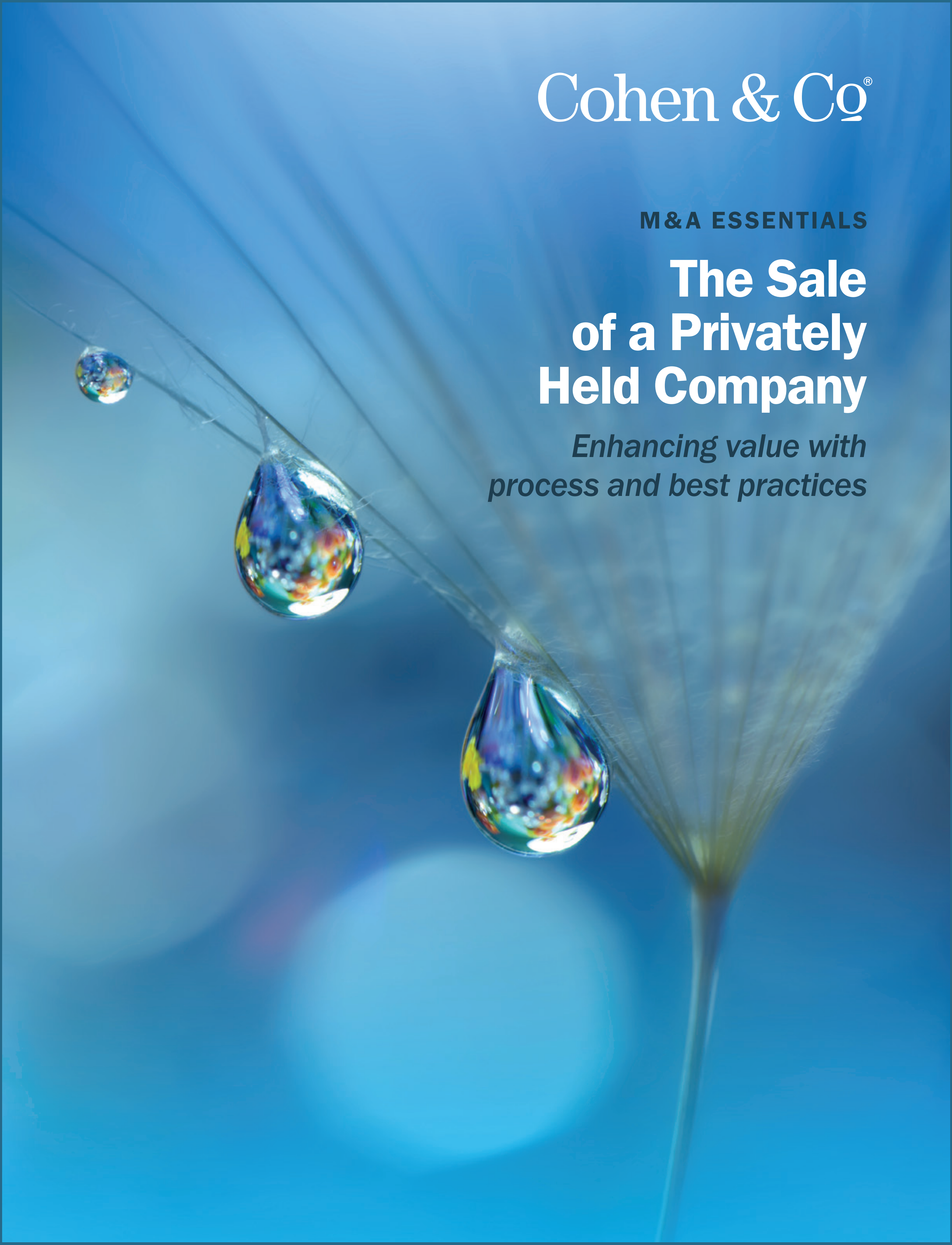

Cohen & Co®

M&A ESSENTIALS

The Sale of a Privately Held Company

Enhancing value with process and best practices

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Businesses are sold for many reasons, but typically issues of timing, liquidity and emotions take center stage. One of the most common drivers of a sale is the need for a succession strategy within family owned companies. Often the decision is purely financial — private companies are highly illiquid assets and a sale can generate liquidity for diversification and financial security. In other situations, entrepreneurs find their drive and passion for the business fades over time. Transactions are also often triggered by unsolicited offers from a competitor or a private equity group, even when the thought of selling wasn't on the radar.

Whatever the driving force for the transaction, selling your business can be an emotional undertaking that may result in serious disruptions unless the process is managed properly. The sale process can impact relationships with suppliers, shareholders, family and employees in ways that can damage the value of the company. A well-managed process, on the other hand, can enhance the value of a business and position the company for a continuing legacy under a new ownership structure.

The sale process is the final stage of the entrepreneurial cycle, when the value of the business is ultimately realized and shareholders redeem their ownership interests. It is a culminating event yielding financial rewards for years of your hard work and assumed risks. To maximize the value of the business, the process must be well planned, well executed and given the attention that any other crucial business event deserves. Planning the process and executing on it in a disciplined manner is the best strategy to help ensure your business is sold to the right buyer, at the best price, and under the most favorable terms and conditions.

"To maximize the value of the business, the [sale] process must be well planned, well executed and given the attention that any other crucial business event deserves."

The Cast of Players

The world of mergers and acquisitions (M&A) involves immense sums of money controlled by buyers, lenders and investors. Understanding these key players and their roles in the process is critical for a seller navigating the M&A arena.

THE BUYERS

Strategic Buyers

Strategic buyers can be public or private companies that target acquisitions for a strategic purpose, such as:

- Gaining market share by purchasing a competitor
- Managing production inputs by acquiring a supplier
- Gaining distribution channels by consolidating a dealer network
- Diversifying business lines or reducing costs
- Leveraging synergies by combining assets

The objective of a strategic buyer is to build value by integrating an acquisition with existing operations, executing a joint strategy and growing revenues, while managing cost structures. From a seller's perspective, the importance of strategic buyers lies in their ability to pay higher values than other buyers. Strategic buyers typically have a unique value proposition that provides a rationale for an acquisition others may lack. Furthermore, they often have greater access to capital at a lower cost. These factors usually translate into an ability to value potential acquisitions higher.

Financial Buyers

Private equity groups constitute the vast majority of financial buyers. Their objective is to acquire companies that generate returns for their investors, including pension funds, university endowments, wealthy individuals, banks and other investment firms. Financial buyers acquire companies using a combination of funds raised from their investors and loans from banks and other capital sources. The investment earns a positive return on their investment as long as profits exceed the cost of capital and the company can later be sold at an attractive valuation. The objective of a financial buyer is to achieve, on average, their targeted return on equity (typically mid to high teens) within a five to seven year time frame.

Given the right price and an appropriate capital structure, financial buyers employ a whole host of strategies to build value. Such strategies include bolstering management teams, improving cost structures, enhancing product offerings, introducing new sales strategies and achieving economies of scale through additional acquisitions.

A financial buyer's objective is to buy at the lowest price possible, grow earnings and eventually sell at the highest possible price once the investment has been held for an optimal period of time. When financial buyers exit their investments, they usually focus on selling to a strategic buyer or private equity groups that focus on larger transactions.

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Private Equity "Add-On" Buyers

When a private equity group acquires a company unique to its current portfolio of investments, it is called a "platform" investment. A common strategy private equity groups use in an effort to command higher valuation metrics during the ultimate sale is to grow the platform by acquiring "add-on investments." Add-ons are generally smaller in size relative to the platform company. Other terms used to describe such transactions are "tuck-ins" or "bolt-ons," each of which has different nuances but also relate to an acquisition that is complimentary to a platform.

Exhibit 1 summarizes key characteristics of the three primary types of buyers. In M&A transactions, it is important for sellers to understand the motivations of potential buyers and communicate accordingly. A strategic buyer and a financial buyer may look at the same acquisition differently. Knowing their "hot buttons" is something you and your deal team can assess through financial analysis, for example, by studying the potential dilution aspects of a deal for a strategic buyer, or by identifying the key elements affecting the returns for a financial buyer. Different buyers often have diverse strategies post-acquisition that sellers should consider as well. For example, if a buyer intends to consolidate operations and the seller desires to keep the company intact as a stand-alone company, you should address this consideration early in the process.

EXHIBIT 1: CATEGORIES OF POTENTIAL BUYERS

	FINANCIAL BUYERS	ADD-ON BUYERS	STRATEGIC BUYERS
PRIMARY OBJECTIVE	Generate returns through growth of earnings combined with financial leverage	Grow portfolio company return through strategic acquisitions	Enhance value through synergistic acquisitions involving market share or cost reduction
FINANCING RESOURCES	Minimal equity, bank loans, subordinated debt, seller notes	Typically the same as financial buyer, but may come from existing cash resources	Sources vary from cash reserves to banks and public/private debt and equity markets
INVESTMENT HORIZON	Medium term	Short to medium term	Longer term
EXPECTED VALUE OF DEAL	Determined by capital structure, projected earnings and return expectations	Can be higher than other financial buyers due to synergies	Typically higher, depending on synergies and ability to pay

THE ADVISERS

An M&A transaction team typically includes key members of your management team in addition to attorneys, accountants and investment bankers. Seamless interaction and coordination within this team while executing the deal can mean the difference between success or failure.

The sale process is often difficult for those who are successful entrepreneurs in their own right but may be overwhelmed when they venture into the unfamiliar world of M&A. A seller's best chance at success is to exercise executive control and daily involvement, while relying on the team to manage its respective responsibilities within the process and coordinate with the rest of the team. You, as the seller, should never completely delegate control of the deal team.

A preemptive due diligence review, known as a Quality of Earnings Report (QofE), conducted early on in the process is a good investment for any business contemplating a transaction.

Legal Counsel

Most companies contemplating a divestiture or a sale already have a law firm relationship in place. However, an attorney who deals with the day-to-day aspects of a business may not have the specialized knowledge required for M&A transactions. An experienced deal attorney is essential in any sale. They are responsible for ensuring the deal is structured and documented properly. The best attorneys know where pitfalls can occur and how to protect their clients well after the deal is closed. Most law firms either have this expertise in-house or know other firms that can assist.

Accounting Advisers

The role of the accounting firm has expanded as the M&A world grows in sophistication. Buyers need to have confidence in the accuracy of the financial statements. Furthermore, the company's accounting firm is pivotal for due diligence when buyers are investigating the business. Planning early for an M&A transaction also means establishing reliable and accurate procedures and reporting systems. A preemptive due diligence review, known as a Quality of Earnings Report (QofE), conducted early on in the process is a good investment for any business contemplating a transaction. "Clean" companies command greater value and withstand pressures by buyers to lower valuations as the deal proceeds. Also, environmental, social and governance (ESG) considerations are no longer relevant only to public companies — these considerations are increasingly considered in private transactions.

Investment Bankers

The third leg of the M&A team is the investment banker, who acts as process manager, financial analyst and head marketer. The investment banker must understand the company, its industry and all of the elements that determine the value of the business. Duties of the banker include the preparation of marketing documents, building financial models, developing a target list of potential buyers, contacting potential buyers and conducting the auction that ultimately maximizes the value of the deal. Good bankers excel at developing the strategy of the deal and adapting the marketing process as it evolves.

3 Questions to Ask When Assembling Your Team

Choosing the right deal team is critical. There are three primary traits to consider regarding any potential team member:

1. Competence
(Do they know what they're doing?)

2. Credibility
(Do they have a good reputation?)

3. Compatibility
(Do they get along with the team?)

Many potential sellers weigh industry knowledge heavily. However, this can be a double-edged sword. The team should be loyal to the seller and not the industry. That said, there are some industries that require specialized expertise, such as insurance brokerage and investment management.

Sellers should assemble an M&A team with the same care and due diligence employed in growing the business over its lifetime. The sales process can be disruptive and time consuming, and you only have one shot at getting it done right. Multiple attempts at selling or changing the team in the midst of a deal is very difficult, and the marketplace will perceive it poorly.

The Process

There is a progression of stages that characterizes most M&A processes. Each deal is different, as are the players, but most well-run deals progress from one stage to the next in similar fashion. Exhibit 2 illustrates a typical deal process. It shows the major stages of the process, tasks performed and the approximate time frame involved in each phase.

EXHIBIT 2: ILLUSTRATION OF THE M&A DEAL PROCESS

PLANNING	DOCUMENT PREPARATION	MARKETING & AUCTION	NEGOTIATIONS	CLOSING
Assemble Advisory Team	Create "Teaser" and Information Memorandum	Develop Target List	Choose Final Bidder	Assemble Final Documents
Formulate Objectives	Prepare Financial Projections	Distribute Memorandums	Coordinate Final Due Diligence	Execute Purchase Agreement
Determine Deal Structure	Draft Confidentiality Agreements	Choose Next Round Groups	Finalize Purchase Agreement	Transfer Funds
Develop Marketing Plan	Construct Data Room	Conduct Management Presentation		
Establish Procedures		Solicit Final Bids		
2 WEEKS	2-4 WEEKS	8 WEEKS	4-6 WEEKS	

PLANNING

The process kicks off as the deal team is assembled. It is essential that objectives are clearly defined and expectations communicated at the beginning to avoid misunderstandings, paying particular attention to:

- Value expectations, including thoughts on non-cash proceeds, such as seller notes and earnouts
- Indemnification requirements
- Expectations for management's post-sale roles
- Potential structures, such as asset vs. stock sale, and full sale vs. partial or leveraged recapitalization

The most important, and most basic, question your team must answer is this: Why would someone be interested in buying the company? Other questions include:

- What characteristics of the company will attract strategic buyers versus financial buyers?
- Is the company a good stand-alone investment or is it a growth play as part of a larger strategy?
- Is the management team capable of operating the company given a reduced management role by the seller?

Once this thesis, or multiple variations of the thesis, is developed, it is important to carry that theme through the entire marketing process.

Finally, planning should encompass establishing deal procedures, including assigning responsibilities, gathering contact information and establishing communication procedures. Detailed planning is important and helps ensure confidentiality by eliminating the risk of careless mistakes.

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DOCUMENT PREPARATION

The next stage of the process is to develop the materials that will communicate critical information to potential buyers. The first task is to create a "teaser," which is used to garner interest in the deal without disclosing either the company's name or information that might allow potential buyers to guess the identity of the seller.

Next, a Confidential Information Memorandum (CIM) is prepared in draft form and revised numerous times before distribution. This document describes the company — its products, markets, customers, competitors and industry, and summarizes historical financial information and projections. The CIM must effectively communicate the marketing themes of the deal. The first few pages of the memorandum, composed of the executive summary and the key investment considerations, provide an opportunity to communicate what is special about the company and why it would make a great acquisition.

The work of constructing a data room, along with preparation of the QofE, begins at this early stage as well. A data room is an electronic collection of documents that contains more detailed information than what is included in the CIM. Such documents include audit reports, employee information, contracts and environmental studies. Honest and accurate disclosure should be the guiding rule in assembling the data room — holding back negative information will result in lower values before closing and likely lawsuits afterwards. Initially, only the CIM and the QofE is available in the data room; access to other documents is provided as the deal progresses. The data room is an excellent tool for tracking interest in the deal as an audit trail is created, which provides data on those documents buyers are looking at and how often.

MARKETING AND AUCTION

Prior to distributing the CIM, a significant amount of research is applied to developing the target list of potential buyers:

- Who are the logical buyers?
- Who has been making acquisitions in the industry?
- Which private equity groups are looking for deals of this size in this industry?

Investment bankers maintain and subscribe to comprehensive databases used to ensure the deal is shown to the right buyers and that no stone is left unturned in the process. Shareholders are often approached by potential buyers who may be good targets, and the industry input of the management team can be valuable.

Once the documents and the target list are complete and accurate, marketing can begin. It starts with direct contacts to potential buyers or a broader distribution of the teaser. After a confidentiality agreement (CA), or a non-disclosure agreement (NDA), is negotiated and signed, the CIM is distributed via the data room. A tracking list of targets is maintained to communicate information on the marketing process to other team members. This report typically contains contact information, milestones (such as "NDA Sent" or "Data Room Entry") and includes notes on discussions requiring communication to the client or other team members.

As the process of CIM distribution continues, the number of parties on the tracking list grows as the investment bank uses their network to expand the target list of acquirers. A skilled banker will add value to the process by finding potential acquirers that might not have seemed intuitive to others, or by pitching the deal to other potential buyers as an idea they might not have otherwise considered.

As potential buyers begin to evaluate the deal, follow-up questions and discussions between the banker and the buyers culminate in a target date by which potential buyers are asked to submit a letter, called an indication of interest (IOI). An IOI is a non-binding document that identifies a value, or range of values, the buyer proposes paying for the company. Other elements of the letter may include deal structure preferences while offering

an opportunity for the buyer to make a case for considering them over others in the acquisition.

The M&A team then sifts through these letters to determine which potential buyers they will recommend advancing to the next stage. This is the point when the market value of the company begins to crystallize. Clues as to how the market assigns value to different aspects of the deal and potential weaknesses in the company's value thesis become apparent at this stage.

Think of the process of marketing a company as a funnel. If the target list begins with 100 potential buyers, perhaps 60 sign an NDA and receive a CIM. If 10 of these groups submit indications of interest, perhaps only five are chosen to meet management and conduct additional due diligence.

Once a smaller group is selected, the management team will make a presentation to buyers, giving them the opportunity to assess the team, discuss strategic issues and tour the facilities. Often the buyers will bring their bankers in anticipation of a financing structure. If presentations and discussions go well and the data room tests out to their satisfaction, potential buyers will likely feel comfortable with the deal and, hopefully, have enough confidence to push their valuations higher to be chosen as the preferred buyer.

However, there are also indicators that can move buyers' perceptions of value in the opposite direction. Common pitfalls that might result in negative perceptions include earnings deterioration, inaccurate or unfavorable information that was not properly disclosed, or a management team that does not instill confidence.

Once the management presentations are finished and the data room has been fully updated, the next task is to choose the best buyer. Potential acquirers are given a couple of weeks to refine their value calculations and line up their financing sources. The investment banker then asks the bidders to submit their final offers. These offers are structured as a draft letter of intent (LOI) that addresses how much buyers propose to pay, the structure of the payment (cash, seller notes, earnouts, etc.), conditions of closing and timing. The letters, although non-binding for the most part, provide the basis for choosing the final bidder. Often the bidders are provided with a draft purchase agreement they are asked to mark up. This can often provide the attorney on the deal team with a sense for the key legal issues the buyer has identified. Choosing the final buyer based solely on value without considering legal aspects is a mistake many sellers come to regret later.

If all has gone well and there is a sense of excitement among the bidders, the seller's clout is at its maximum level. This is when that last morsel of value can be extracted through the competitive auction process when bidders are asked: "Which of you wants to buy this company more than anyone else?"

NEGOTIATIONS AND CLOSING

Once the buyer is selected, the push and pull of the final negotiations begins. The LOI is signed and final negotiations and due diligence commence. This is the stage when the investment banker moves to the background, passing the lead role of process manager to the deal attorney. Following execution of the final purchase agreement, ownership changes hands and funds are transferred.

Process Maximizes Value

Your company may have tremendous perceived value, but if the sale process is flawed, that value cannot be realized. Worse yet, a flawed process could inflict permanent damage, for example, if trade secrets make their way to competitors or if employees, frightened by the prospects of a sale, choose to seek employment elsewhere.

Using an ad hoc approach — without a road map and a professional deal team — will rarely result in realizing your company's true value. A carefully managed, well-executed, comprehensive and competitive process ensures all potential buyers came to the table with their best offers, maximizing value and rewarding you and your shareholders for all of your efforts in creating a valuable enterprise.

Contact Us for Help

Our M&A Advisory team combines the transaction experience of seasoned investment bankers with specialists in due diligence, tax and accounting to help optimize your M&A deal. We can consult on specific issues or coordinate your entire transaction process.

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