

Merger & Acquisition Connection

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An acquisition, now?

Don't let the economy hinder your plans

If your company has tabled its expansion plans until the economy rebounds, you might want to reconsider that move. Costly growth initiatives, such as M&As, may seem counterintuitive when money's tight and the future's uncertain. But for well-positioned companies, there are advantages to making an acquisition in a down market.

Shrinking or growing?

Most companies are operating conservatively these days — cutting costs, building cash cushions and putting off capital-intensive plans. Although it may make sense for struggling businesses to retreat into their shells, their more financially solid peers could be missing important opportunities.

Even in a challenging economy, you need to focus on revenue and earnings growth, and growth is nearly impossible to pursue if you're sitting on the sidelines. Instead, review your long-term strategic plan and determine what's working and what isn't. You might consider divesting your company of unsuccessful units or those that don't fit your broader strategic plan so that you can better focus resources on those product lines and divisions with growth potential. Assuming your company is fundamentally sound,



an acquisition could become a critical part of this revised strategy, offering increased market share and potentially reduced expenses through cost synergies.

Question of financing

Finding financing remains a major obstacle for would-be business buyers. A tight credit environment means that traditional lenders have raised qualification criteria higher than many borrowers — particularly those with debt-heavy balance sheets — can meet. Companies pursuing larger acquisitions (generally more than \$3 million) face significant challenges.

The advantage of buying low, of course, is that your investment has that much more upside potential.

Even if you're relatively debt-free and qualify for bank financing, your lender may impose strict covenants that prevent you from pursuing other plans, such as taking on additional debt to finance new operations. But if you've lined up a lender offering good terms (such as a bank with which you have a longstanding relationship) or an investment partner (such as a private equity fund), or have the cash to buy a business on your own, *now* is an excellent time to consider an acquisition.

With less competition from other buyers, you may, depending on the industry, have your pick of quality companies. Although the M&A landscape is littered with financially distressed businesses, companies that have relatively minor, short-term issues and great long-term potential are selling for pennies on the dollar.

The best companies will likely never be forced to sell dirt cheap. But motivated sellers, including the growing ranks of retiring baby boomer business owners, are more likely to agree to creative deal

structures, including seller financing, to complete a transaction. (See “Solving the credit conundrum with seller financing” on page 5.)

Buy low, watch it grow

The advantage of buying low, of course, is that your investment has that much more upside potential. There’s no guarantee that a “bargain” acquisition will pay off — M&As always carry some risk of failure. And there’s certainly no telling when the economy will rebound.

But if you acquire a company in the same industry and geographic area, with similar or complementary products, and a compatible corporate culture, you’ll enjoy a much better chance of success. The economic

slump may provide an especially good opportunity to buy that competitor you’ve been eyeing for years. Be certain, however, that you perform even more thorough than usual due diligence on any company priced significantly below market. Some companies are cheap for a reason.

Opportunity not opportunistic

Before you go bargain-hunting, you need to do some serious soul-searching. Are you pursuing an acquisition because it fits your broader strategic plan and you’re ready to devote the time, energy and funds to make the acquisition work? Or are you looking to buy because you see a deal that’s “too good to pass up”? Even when opportunities seem great, opportunistic-only acquisitions rarely are. ■

How IT fits into M&A

Businesses depend on information technology (IT) for everything from simple communications to voluminous data storage and complex financial transactions. So it’s surprising how often IT is one of the last issues considered during a merger.

Even when business buyers expect cost synergies from combining organizations, they may not anticipate what the integration of disparate IT systems entails — including the price tag. And both buyers and sellers frequently fail to plan for IT employee issues, such as layoffs, key staff retention and the assignment of management positions. Often, IT workers have exclusive knowledge about a company’s systems and software — knowledge that the company needs to preserve. So if you’re planning a deal, neglect IT integration at your peril; such neglect may undo the best-laid M&A plans.

Start now

The key to successful IT integration is for a buyer to start planning for it even before making an offer. In fact, you should incorporate IT into your target search criteria, looking for companies that have technology systems, operations and even cultures compatible with your own.

Include your chief information officer or other IT manager as part of your M&A deal team, and consider engaging an outside IT integration expert — even before you reach the integration stage. These team members will be able to assess compatibility and help determine whether synergies such as sharing the costs for off-site data storage or disaster recovery services will be significant. It’s possible that IT integration will be costly and time-consuming or require expensive new systems, thus eroding the deal’s value.

Sellers also need to plan for IT issues well in advance of signing the sale agreement. While preparing to go on the market, sellers should determine which IT employees contribute significantly to their business’s value and offer those staff members retention packages that include, for example, deferred bonuses or stock options.

Sellers also should ensure that the IT department’s policies, procedures and processes are well documented so that the future owner and its employees can easily access and understand them. Smaller companies in particular often neglect documentation and risk losing



valuable information if, for example, the one programmer who customized critical software leaves.

Due diligence decisions

Once buyers have a target, they need to include IT systems in the due diligence process. Your due diligence team should pay particular attention to payroll and billing systems, infrastructure and security and determine how they overlap with your company's resources. Also decide which parts of the target company's system you intend to migrate to your organization and how long this process is likely to take.

At this stage, some buyers may decide that combining the two systems is too time-consuming or expensive, particularly if both systems require significant upgrades. Scrapping both and starting over from scratch can be expensive, but it also enables faster consolidation and eliminates decisions about which organization's technology architecture will survive.

Whether you keep elements of the old system or wipe the slate clean, you're likely to have staff redundancies. Don't automatically eliminate your target's staff to retain your own. Work with your HR department and the seller to review each employee's experience and skills — you may find the target's employees have critical expertise that your employees lack, such

as expertise building and maintaining Web sites. Similarly, your target's IT managers may be better equipped to lead the integration process and manage the consolidated IT department once the acquisition is complete.

Finally, don't forget the outsourcing option. Outsourcing may be more cost-effective than retaining current staff or absorbing your target's, particularly if you're starting over with new infrastructure.

Expect the unexpected

Once you've made these important decisions, develop reasonable timelines — from 90 days to a year or more, depending on the size of each company and extent of the systems. Remember that IT integration typically includes not only data networks, hardware, software, e-mail and company Web sites, but also telecommunication and other systems.

Although you may be tempted to try to complete IT integration as soon as possible, know that even detailed plans can't prepare you for challenges that inevitably pop up along the way. So build in plenty of time to do the job right, and make sure your plan is flexible enough to allow for revisions.

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Professional help

Small companies may be able to merge IT departments on their own. But most M&As benefit from the assistance of an IT integration expert. This professional can help ensure you're considering every element of the merger and devising realistic integration timelines, as well as work with your IT staff to keep the process moving until you achieve your goals. Your M&A advisor will be able to recommend a qualified IT integration expert. ■

Solving the credit conundrum with seller financing

The U.S. credit markets are showing signs of thawing. But it's likely to take some time before the economy emerges from its deep freeze and the government's stimulus funding significantly affects the lending practices of banks. In the near term at least, many potential business buyers may find themselves short of the financing they need to make an acquisition.

Sellers serious about moving on and completing a deal may be able to help buyers in the form of seller financing. With these M&A deal structures, buyers typically use cash or loans for part of the acquisition price and give sellers a note, or promise to make installment payments for the remaining amount.

Hard times, hard choices

Since late 2007, the M&A marketplace has been extremely sluggish as buyers struggle to find funds and sellers wait for a more amenable environment. Some owners, however, can't afford to wait — either because they're anxious to retire or move on to other ventures, or because their companies are too financially distressed to survive as stand-alone entities. By offering partial financing, sellers can help close a deal already in the works or even attract competing bidders on the open market.

Seller financing isn't the solution for every deal experiencing a shortfall, but it can work if the seller doesn't need to receive payment for the full sales price immediately. The seller also needs to have complete confidence in the buyer's management team so it can be reasonably certain the merged company will be profitable enough to repay its debt.

Buy now, pay later

Most seller-financed transactions take one of two forms:

1. Loans. The seller accepts a promissory note for future repayment with interest — generally at a higher-than-market-average rate. Typically, buyers provide as collateral their own company and, possibly, personal assets such as their home. In the event of default, the seller can claim this collateral without formal litigation. Seller loans, however, are typically subordinated to the buyer's senior debt, so sellers



should carefully review the terms of the buyer's agreements with its bank lenders.

2. Installment plans. In this case, buyers pay sellers a down payment on the transaction's closing date. The buyer then pays the remainder in periodic installments, typically over five to seven years. Buyers typically prefer installment plans because, unlike loans, they don't show up as debt on their balance sheets. Although sellers accept more risk with this type of transaction, they enjoy current tax savings from deferring a portion of the sale's taxable gains. However, it's important for sellers to keep in mind that tax rates could go up in the future, potentially making tax deferral costly.

It may also be possible to structure a seller-financed deal to include future royalties or sales commissions,

or an employment or consulting contract for the selling owner. Continued involvement in the business can be a particularly attractive option if the seller is concerned about the security of any seller-financed loans. But owners need to discuss the tax consequences of future employment or contract work with their financial advisors before electing this option.

Get the deal done

Seller financing isn't the only option for buyers unable to qualify for adequate bank debt. Earnouts, mezzanine and other types of subordinated loans, and private equity partnerships may be available to help bridge financing gaps. The key is for both buyers and sellers to be willing to explore nontraditional financing solutions to get the deal done. ■

Solvency opinions

Appease stakeholders' leveraged deal anxiety

Traditionally, companies have asked independent financial experts to render solvency opinions to assure boards and lenders that a highly leveraged transaction is unlikely to expose the company to excessive or unnecessary risk. These opinions are usually required in cases of leveraged buyouts or leveraged recapitalizations, but in today's challenging economic environment, even ordinary deals can pose extraordinary risk. Stakeholders are understandably concerned about potential liability.

The trouble with leveraged deals

In most leveraged restructurings, the financing proceeds are used either to buy out selling shareholders or pay a large dividend. The restructuring company's liabilities therefore increase significantly without a corresponding increase in assets. This often results in the market value of assets exceeding their book value — a situation that, alone, doesn't necessarily warrant concern. But it does put the company at risk



for insolvency, which happens when liabilities exceed asset values.

The degree of leverage imposed in many buyout or restructuring deals increases the possibility that a company's assets may be lower than its liabilities — even on a fair market value basis. Thinly capitalized transactions raise worries about borrowers' ability to pay debts, especially when their solvency is conditional on large asset sales or near-term refinancing of higher-yield debt. Interest rate hikes, in particular, can be troublesome for highly leveraged businesses operating with little margin for error, because larger debt payments may push them into bankruptcy.

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What's more, the structure of highly leveraged deals doesn't provide much assurance to directors and lenders that adequate consideration was received, because the loan proceeds are paid out to the company's selling shareholders rather than reinvested in the business.

When fraud's a factor

A company's solvency involves more than its ability to repay debt. Fraud risk is also a major concern and, in fact, some laws specifically address the potential for "fraudulent conveyance."

The Uniform Fraudulent Conveyance Act and the Bankruptcy Code set up several tests, or "badges of fraud," to determine actual or unintentional fraud. Malfesance has occurred if a transfer is made with actual intent to defraud an existing creditor or if a transfer is made for "inadequate consideration" causing the company to fail three solvency tests. These tests are:

1. That the fair value of the company's assets exceeds its liabilities (referred to as the balance sheet test),
2. That the company will be able to meet its debt obligations as they mature, and



3. That it has a reasonable amount of capital to continue running the company after the transaction.

Under fraudulent conveyance laws, if a debtor can't pay its obligations and files for bankruptcy, unsecured creditors can attempt to have senior lenders' security claims voided and subordinated. If the secured loan's proceeds bought out shareholders or paid a dividend, the entire transaction may be voided and the proceeds returned to the seller. Corporate directors may face the additional prospect of shareholder suits.

An effective opinion

Companies can reduce or eliminate such concerns with a solvency opinion prepared by a third-party expert with no personal stake in the transaction. Such experts determine whether the company passes the three solvency tests by reviewing financial statements and loan and shareholder agreements, among other information.

They also test management's forecasts for reasonableness and subject them to sensitivity analysis to, for example, determine what effect changes in macroeconomic conditions and company- and industry-specific factors have on company sales and profitability. And they consider the effect of refinancing.

Peace of mind

Market volatility, rising interest rates, shareholder activism and court applications of fraudulent conveyance law to leveraged transactions can make secured lenders and corporate directors nervous. By providing them with an expert opinion that the transaction is reasonable, you'll be able to keep your deal on track. ■

AMAA Network

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