BUSINESS GROWTH BY ACQUISITION

WHITE PAPER

AFFINITY VENTURES

Bruce Burns
Affinity Ventures
6121 Indian School Rd.
Ste 101
Albuquerque, NM
87110
Phone: 505-881-5352
www.affinityventures.com

Introduction

This white paper is dedicated to the owner seeking to exit his or her business in style. Acquiring other businesses is a tool that business owners use when growing their own businesses. The operative word is *growing,* since the purpose of growing your business through acquisition is to increase the value of your existing business.

Recall the first three Steps of The BEI Seven Step Exit Planning Process™:

1. Set Exit Objectives.
2. Determine the value of your business.
3. Increase the value of the business.

This white paper will help you accomplish Step Three.

Growing your business by acquisition can be an effective technique to achieve Step Three. A primary Exit Objective held by almost all business owners is to leave the business when they want and with sufficient cash to provide financial independence for the rest of their lives. In fact, *when* they leave is usually determined by the point at which they *can* leave with assured financial security. For most owners, meeting retirement objectives is a function of having sufficient value within the business to permit their departures.

For owners who experience a disparity between when they want to leave and when they are able to leave, an effective shortcut is to grow value by acquiring an additional buyer before becoming a seller. Although paradoxical on its face, the end result of becoming a buyer now may allow you to become a seller sooner rather than later.

Growing Your Business Through Acquisition

In today's dynamic business climate, growing your business through acquisition is a popular option. The growth in popularity of this technique can be attributed to a number of factors: the relatively low cost of financing, the slow and uncertain path of organic growth, aggressive industry consolidators pursuing market share, and the large number of baby-boomer owners eager to sell and pursue other activities.

Most owners are intelligent, hard-driving, successful entrepreneurs. However, they rarely have every base covered and often cannot plan for every contingency in the acquisition process. Recognizing this, they consult a transaction attorney.

At the first meeting with a business owner (whom we will call "buyers" in this article) about the process of growing a business through acquisition, we can usually assume the following:

1. We are discussing a privately owned company (not a publicly traded company) acquiring another privately owned company.
2. The buyer (i.e., the business owner, more specifically, you) has already initiated the acquisition process in some manner.
3. The buyer probably has identified one or more prospective acquisition targets.
4. The targets the buyer has identified may be similar in size but are generally smaller. It is quite rare for a buyer to acquire a company significantly larger than his or her own.

5. Typical acquisition targets are either direct competitors or are somehow related to the buyer's industry, making a strategic acquisition good business sense.
6. The buyer and the owner of the target probably know each other or are at least aware of each other.
7. The buyer has already identified the reasons that make this acquisition attractive.
8. In all likelihood, the buyer has not spent enough time with his or her lawyer and accountant to maximize the advantages and tax-planning opportunities available in this process.
9. The buyer has not given adequate thought to how he or she will pay for the acquisition. In the worst case, the buyer hopes that the seller will finance part of the purchase price by taking back a promissory note. In the best case, the buyer can write a check for the full purchase price immediately.
10. Post-closing integration of the two companies has not been given enough consideration.

Part of the attorney's role is to test these assumptions and educate the buyer at the outset as to how the acquisition process generally works. A prepared buyer increases the possibility of success.

As a business owner, you have probably spent more time imagining yourself as a "seller" than as a "buyer." During the acquisition process, this seller mind-set will enable you to identify with and maneuver around many of the issues that will concern the seller. Thus, growing the business through acquisition can benefit you in two ways: First, it allows you accomplish Step Three of the Exit Planning Process. Second, it allows you to see the sale process from the lens of the buyer, which may help you plan your exit more efficiently when you become a seller. Let's look at what makes a prepared buyer.

A Prepared Buyer

A prepared buyer completes each of the following steps:

1. Assembles a team of knowledgeable and experienced transaction attorneys and financial representatives: either an investment banker, CPA, or both.
2. Has financing in place.
3. Is patient, because he or she understands that every deal has peaks and valleys.
4. Knows that the only good deal is one in which both the buyer and seller will benefit.

The prepared buyer and his or her advisors choose the team members who will act as "lead negotiators," both with regard to financial items (e.g., purchase price, sale structure—asset vs. stock—and form of payment, cash vs. stock) and legal matters. The lead negotiator for the financial items is usually the buyer's financial advisor (CPA or investment banker). Once the financial issues have been resolved, the buyer's transaction attorney will negotiate the legal items with the seller's attorney. In either case, the lead negotiator acts as a buffer between the buyer and the seller. He or she protects the buyer from on-the-spot decision-making. Answering the seller's demands with, "I'll discuss that with my client and get back to you," gives the buyer the time he or she needs to make thoughtful, informed decisions. Meanwhile, the buyer can concentrate on developing a working relationship with the seller (businessperson to businessperson). When difficulties arise (notice that we did not say "if": Difficulties will arise no matter how prepared you think you are), you will be in a position to smooth things over.

In addition, the lead negotiator will do the following:

1. Know which questions to ask.
2. Recognize which points he or she is likely to win and which points he or she will probably lose or compromise on.
3. Move the deal along at a reasonably quick pace.
4. Maintain credibility at all times.

Attorney's Role in the Acquisition Process

To help a business owner grow through acquisition, the transaction attorney must be capable of playing a number of roles. These include the following:

1. Conducting thorough legal due diligence.
2. Analyzing the structure of the deal.
3. Negotiating and drafting legal documents.
4. Analyzing the tax ramifications.
5. Making sure all of the "i's" are dotted and "t's" are crossed.
6. Keeping all advisors and all parties focused on one objective: *closing the deal*. **This is the most important role the attorney has.** No personalities, egos, or conflicting agendas should be allowed to delay or derail closing.

This last task requires finesse on the part of the transaction attorney. He or she must not allow lawyers to "over-lawyer." He or she must be able to move conservative financial professionals toward a reasonable compromise and prevent tax attorneys from sinking in the ultimate quagmire, commonly known as the Internal Revenue Code. Above all else, the transaction attorney must be a deal maker, not a deal breaker.

Now that we know something about the players, let's look at what motivates business owners to dive into this process.

Typical Reasons for Acquisition

Buyers are typically motivated to use acquisition as a means to grow for the following reasons:

- Become more diversified.
- Reduce competition.
- Increase market share.
- Attain economies of scale.
- Expand geographically.
- Establish strategic alliances.
- Achieve greater leverage with vendors.
- Add new lines of goods or services.
- Provide enhanced growth opportunities for employees.

The reasons for acquisition are all beneficial to the buyer in some way, shape, or form if acquisitions are done properly. Keep in mind that any acquisition, no matter the motive, must be part of your overall Exit Plan. The fundamental reason for making an acquisition is to generate *greater earnings*, which will in turn *increase the value of your* *company*. Greater value positions your company to be sold for a premium price and on a time frame that you establish, which is the goal of Exit Planning.

If growing through acquisition fits your Exit Plan, then which criteria should you establish for choosing an acquisition target? You should look for a good, strong, solidly performing company with a consistent history of growth and earnings and with upside potential. Though searching for "turnaround projects" may seem like a good idea, you need to be careful; unless you have the chops of a Wilbur Ross Jr., turnarounds can be financial sinkholes. A turnaround is a company that has been consistently underperforming, lacks direction and leadership, and whose owner is anxious to sell for less than top dollar (often, significantly less). Remember, you are buying someone's failures and problems and that you don't really know how deep the water is until you jump in.

It is no surprise that most buyers have far more success creating value when purchasing a solid, well-performing company. Obviously, the solid, well-performing company will cost more initially, but its existing strengths will enable you to achieve your objectives faster, with less risk, and without forcing you to rack your brain to make the business a source of value (strong businesses already have that built in).

If you already know the type of acquisition you wish to make but haven't located a suitable target, you should contact an investment banker or industry specialist (if, in fact, one exists) to help you develop and implement a buyer search program. The investment banker can research and identify potential targets, initiate contact, determine the target's interest level, conduct financial due diligence, and assist in negotiating the transaction.

Even if you have not retained an investment banker upon finding a viable seller, someone needs to make the initial contact. If you don't know the seller personally, that "someone" should be one of your professional advisors. Remember, the first contact is critical: It sets the tone and kicks off the negotiation process.

In a "typical" transaction, the business owner's accountant or transaction attorney takes the following actions. First, he or she contacts the acquisition target through a letter stating that he or she represents a serious and qualified buyer who has identified the seller's company as one that fits the buyer's acquisition criteria. Second, he or she indicates that he or she will call the target again soon to discuss the matter further. During the subsequent telephone call, an experienced transaction professional can gauge the seller's state of mind and interest level fairly accurately. Once the seller's interest level has been confirmed, the buyer and seller are introduced.

As stated earlier, it is important to establish a rapport with the seller on a businessperson-to-businessperson basis. This will enable you to learn more about the business; its operations, customers, vendors, and employees; and growth potential. Business owners love to talk about their companies, so encourage this. The more you know about the seller as a person and entrepreneur, the more informed your acquisition will be.

Further, your role as a buyer during the acquisition process is to tell your story. You may want to acknowledge that the seller's company fits your criteria and share your vision as to how the seller's business fits into your strategic game plan. Most importantly, you must continuously educate the seller about why your offer enables the seller to achieve his or her exit strategy.

Needless to say, the dynamics of each transaction and the personalities involved differ. Therefore, it is important that you work closely with your transaction attorney to develop a strategy that fits your particular situation.

Once contact has been established, be prepared to sign a confidentiality agreement. If you are a competitor, show the seller that you understand and respect his or her need for confidentiality. All sellers are justifiably paranoid concerning confidentiality. Put yourself in the seller's shoes: You would never want your employees, customers, or competitors to know that you are for sale.

The confidentiality agreement requires both parties to maintain strict confidentiality about the information exchanged between them. It also prohibits the buyer from using confidential information for any purpose other than evaluating the contemplated transaction.

If you extend an offer to purchase and the seller accepts, your counsel should then draft the letter of intent. The letter should be simple and do the following:

1. Identify the parties.
2. Name the purchase price.
3. Explain how the purchase price will be paid.
4. Identify the conditions that must be fufilled to your satisfaction in order for you to close.
5. Include a "stand still" paragraph, whereby the seller agrees to take the company off the market and not entertain other offers.
6. Make clear that the letter of intent is nonbinding, except for certain provisions.

Once the letter of intent has been signed, your financial advisors will conduct detailed financial due diligence. This process is designed to confirm that your valuation of the company is accurate. This analysis can often uncover inaccurate reporting by the seller and lead to negotiated reductions in the purchase price. Make sure that you pay attention to this process; you will be on the other side of the table in the future and can learn from some of the seller's mistakes.

Concurrently, legal counsel will conduct full and complete due diligence of all legal matters affecting the company. During financial and legal due diligence, it is everyone's job to uncover everything there is to know about the seller's business. Your role during this part of the process is to allow your advisors to carry the ball while you remain available as a liaison or facilitator if negotiations start to bog down.

Remember: The seller, by necessity, may become your key employee, and it is important to both of you that this relationship not be tainted.

The Structure of the Deal

With the help of your advisors, you need to determine whether you will purchase assets or stock.

As a general rule, buyers prefer to purchase assets, and sellers prefer to sell stock. A buyer prefers an asset purchase because he or she does not want to assume any of the seller's liabilities and wants the more-favorable tax treatment that an asset purchase offers. If you buy assets, you should be able to deduct most of the purchase price in some form over a period of a few years.

If you buy stock, then you inherit and assume all of the company's known and unknown liabilities. Generally speaking, you will not receive the same favorable tax benefits inherent to an asset purchase.

Payment of the purchase price

Most sellers would prefer to receive 100% of the purchase price in cash at closing. In sellers' markets, sellers of well-performing companies can command and receive either a full cash or stock buyout.

As previously mentioned, a prepared buyer has his or her financial package in order. Thus, you need to determine what your true financial capabilities are prior to identifying the target. You should know how much equity you can contribute and how much you can borrow against both your company's assets and your personal assets (if you are willing to put them into play). The missing piece is always how much you will be able to borrow for the proposed acquisition.

Knowing your own financial capabilities will dictate whether you must ask the seller to carry part of the purchase price back. Keep in mind that requiring the seller to act as your lender may knock you out of the running for the business. In sellers' markets, there are far more financially qualified buyers than there are good companies for sale.

Negotiating points

Clearly, the purchase price, deal structure, and payment of the purchase price are the most hotly negotiated items. After these, expect the buyer's warranties and representations, the covenant not to compete, and the consulting or employment agreement to require much of your legal counsel's time and energy.

Warranties and representations

The warranties and representations make up the buyer's insurance policy. Thus, the description of warranties and representations comprises the longest section in the definitive purchase agreement. As a buyer, you want the seller to warrant and represent to you that, except as specifically disclosed in this section of the contract, there are absolutely no problems of any kind with the company. The warranties and representations include but are not limited to the following:

1. **Corporate standing.** Is the business in good standing in the jurisdiction in which it is located?
2. **Authority to consummate the deal.** Can the seller do what he or she says he or she is going to do, or does he or she need the consent of a third party?
3. **Capitalization.** Does the seller own his or her shares freely and clearly?
4. **Financial statements.** Is the financial information provided true and accurate?

5. **Absence of changes.** Has the seller conducted business consistently with how he or she has conducted business in the past?
6. **Contracts.** Have you seen all of the contracts that bind the seller? Has he or she defaulted on any?
7. **Title.** Does the seller have free and clear title to the assets he or she is selling?
8. **Property.** Has the seller complied with his or her lease? Is he or she in violation of any zoning rules?
9. **Penalties or threatened litigation.** Is the seller in compliance with all applicable laws, and does he or she have reason to suspect future litigation?
10. **Governmental consents.** Have all such consents been acquired, and can they be transferred to the buyer?
11. **Accounts receivable.** Can the buyer depend on the seller's list without offset?
12. **Compliance with laws.** Have all applicable laws been adhered to?
13. **Environmental issues.** Have all permits been maintained? Have all issues been disclosed?
14. **Insurance.** Are all types of insurance required to conduct business in force?
15. **Tax matters.** Are all returns filed and taxes paid?
16. **Employment issues.** Are all payments made as due? Are there any outstanding claims or threatened actions?
17. **Patents.** Are there any patents owned by the business or any possible infringements?
18. **ERISA issues.** Have all benefit plans been administered in compliance with ERISA requirements?

If, after the closing, you uncover facts that were either misrepresented or not disclosed and as a result of these facts you are damaged, then any legal cause of action that you may have will be based on proving a breach of a warranty or representation. If each party's legal counsel is experienced in transactions, there will be some give and take relating to the warranties and representations, indemnifications, and the no-compete clauses, but there will be an end to the process. Dealing with an attorney who is not familiar with this process and requires lengthy negotiations on matters that are ordinarily non-negotiable becomes quite costly—in both time and money—so be certain that your attorney is indeed well-versed in transactions.

Consulting agreements and covenants not to compete

Even if you don't want the seller to remain as an employee, you will nonetheless require a consulting agreement designed to keep the seller in place for an agreed-on period of time in order to properly transfer the company. If you want the seller to become a permanent employee, then a well-considered employment agreement, including a covenant not to compete, is a necessity.

In addition to the covenant-not-to-compete clause contained in the employment agreement, there will be a separate covenant not to compete in the definitive purchase agreement. For example, the general rule of law in Colorado is that covenants not to compete are not binding. However, a covenant not to compete in connection with and as a result of the sale of a business is an exception to this general rule. Therefore, it is valid and binding as long as it is reasonable in geographic scope and duration of time. (Please check with an attorney in your state about the enforceability of covenants not to compete.) As a buyer, you will obviously require a covenant not to compete that offers you sufficient time to become established in the marketplace.

Conclusion

Don't be a "do it yourselfer." In sellers' markets, you must be organized and prepared to move swiftly. Too often, frustrated buyers first try to represent themselves and then complain that just when they thought they had a deal, they were outbid by a third party, typically a publicly owned consolidator. During our postmortem, they realize that they were not properly organized or represented and didn't know that they were simply being used by the seller as negotiating fodder to extract a better offer from a party with deeper pockets.

Keep in mind that the purpose of acquiring another business is to increase the earnings and value of your company so that you, in turn, can become a seller and leave your business in style. If this goal cannot be achieved via the contemplated transaction, then you must seriously examine your acquisition strategy and the transaction itself.