Volume Four ✦ Number One

EXIT STRATEGY

Strategies for valuing a company, building its market value and preparing for a future sale

Customer Concentration

Many small to mid-sized businesses have customer concentration issues, with one to three customers accounting for a high percentage of a company's total revenue or profit.

Acquirers are typically concerned when an individual customer accounts for more than 10%-20% of the overall revenue. When a potential concentration issue exists, it is important to appreciate and view the concerns from the perspective of a potential acquirer. This insight can help to identify a creative deal structure that mitigates the risk in a manner acceptable to both the buyer and seller.

Common concerns and questions include:

- What would be the impact from the loss of a major customer?
- How "easy" is it for the customer to switch to a competitor and what could cause that to happen?
- Is there a "special" relationship between the current owner/business and the customer that protects future revenues?
- What can be done to reduce this percentage of concentration?

An acquirer's concern in this area could translate to a reduction in valuation or a retention requirement to structure a purchase price adjustment in the event that one or more customers are lost post-closing, during a defined period.

Assuming a company has one or more customers that account for a large percentage of the revenues, there are a few strategies that can be implemented to mitigate a buyer's concern. The best initial strategy is to address the issue with proper presentation, before it is questioned by an acquirer and needs to be explained or defended. Later strategies include transactional deal structures that bridge the "risk gap." Customer concentration is an important issue to most buyers.

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Multiple Contacts. A buyer will be more comfortable if you can demonstrate that multiple employees have contact with the customer and/or relationships exist with multiple people within the customer's organization. This significantly decreases perceived risk by reducing the possibility that one person will leave the company and take the relationship with them.

Barriers to Exit. In certain situations and industries, there may be significant barriers that discourage a company from ending a relationship and going to a competitor. These include exclusive distribution agreements, limited availability of competitors with the ability (people, equipment, expertise, etc.) to service the client, contractual supply relationships, etc. Should these situations exist, it is important to confirm how they may be impacted by a change in ownership. In certain industries, there may be agency approvals required to change vendors. This is common in the pharmaceutical

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The Inner Workings Of Private Equity Buyout Groups

Private Equity refers to business investment funds focused on making equity investments in non-public companies. For the majority of middle market companies, private equity refers to buyout groups that seek to acquire ongoing, profitable businesses with realistic growth potential.

During the past several years there has been a significant increase in the number of private company buyout groups. The private equity market had traditionally been restricted to acquiring larger companies (over $25 million in revenue); however, several factors have attracted them to smaller firms. These include competition for larger opportunities; greater growth potential of smaller companies and less mature industries; and a clearer path to "exiting" the investment in the future, through a sale to a larger group or strategic buyer.

Private Equity Groups/Funds (PEGS) are organized as limited partnerships that are controlled and managed by the private equity firm that acts as the general partner. The purpose of the fund is to invest in privately held companies with the objective of generating above market financial returns for the investors.

"There has been a significant increase in the number of private company buyout groups."

The fund obtains commitments from certain qualified investors such as pension funds, financial institutions and wealthy individuals to invest a specified amount. These investors become passive limited partners in the fund partnership and, at such time as the general partner identifies an appropriate investment opportunity, it is entitled to draw out the required amount or to

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Private Equity Buyout Groups

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"call" the required equity capital. All investment decisions are made by the General Partner, which also manages the fund's investments (commonly referred to as the "portfolio"). Over the life of a fund, which often extends up to ten years, the fund will make multiple investments in diverse businesses.

PEG acquisitions are segmented as platform or add-on acquisitions. "Platform" companies must be able to stand alone and provide a strong entry into an industry. "Add-on" acquisitions have a strategic or synergistic fit with existing platform companies. Add-on acquisitions can be significantly smaller than stand alone platform investments, assuming there is a strong "value add" synergy to the existing platform company. This could be new products, expanded geographic coverage, human resource talent, distribution channels, etc.

For PEG's, the most reliable source of potential acquisition opportunities are merger & acquisition intermediaries that routinely represent small and mid-market privately held firms. Sun M&A maintains current files of more than 500 active PEG's with their investment preferences and criteria. We also subscribe to databases that enable Sun to target PEG's based upon existing investment portfolios.

> *"Add-on acquisitions can be significantly smaller than stand alone platform investments, assuming there is a strong 'value add' synergy to the existing platform company."*

The strategy and focus of these groups varies widely, with different groups having varied investment philosophies and transaction structure preferences. Some prefer complete ownership, while others are happy with a majority or minority interest in acquired companies. Some limit themselves geographically, while others will buy anywhere in the US. There are those that require platform companies to generate a minimum of $20 million annual sales, while others will consider candidates in the $10 million sales range. Some will consider distressed companies, but most require steady historic cash flows.

PEG's tend to have certain things in common. They typically target companies with relatively stable product life cycles; avoid leading-edge technology (this is what venture capitalists want); and have a preference toward stable and established product lines or services. Most prefer a qualified management team that will continue to run day-to-day operations while the group's principals closely support them on the Board of Director level. The fund's "value add" is to provide insights and expertise; structure further add-on acquisitions; and provide access to capital, to increase market share and operating efficiencies. PEG's commonly pay substantially all cash for the acquired company since they are well-qualified to get their own primary and secondary financing.

Buyout group investments take many forms and vary depending upon the fund and the Seller's preference:

Outright Sale. This is common when an owner wishes to sell his ownership interest and transition into retirement. Either existing management will be elevated to run the company or an acquirer will bring in additional senior management. A critical factor is whether the company can continue to thrive without the current owner. If not, a mid-term transition period may be required to train replacement management and transition key relationships.

Recapitalization. This is an ideal alternative for an owner who wishes to sell a portion of the company for liquidity or estate planning purposes, while retaining equity ownership to participate in the company's future upside potential. This structure allows the owner to achieve personal liquidity; eliminate personal guarantees; retain significant operational input and responsibility; and gain a financial partner to help capitalize on strategic expansion opportunities.

This recapitalization structure works well when an owner wants to diversify financially and take a significant amount of money "off the table" that is currently locked into the business. A major benefit of a recapitalization structure is that the Seller can retain an equity ownership position and continue running the business, while having the opportunity to take a "second bite at the apple" in the future by selling their smaller remaining stake in a much larger company. It is not unusual for the retained minority interest to yield a greater value than the original sale, due to the expansion of the company.

> *"This recapitalization structure works well when an owner wants to diversify financially and take a significant amount of money 'off the table.'"*

Growth Capital. Growing a business often strains cash flow and requires significant access to additional working capital. A growth capital investment provides access to non-recourse capital and permits management to focus on running the business without constantly having to be concerned with cash flow matters. Capital is also available for future synergistic acquisition opportunities.

Family Succession. Often this type of transaction involves backing certain members of family management in acquiring ownership from the senior generation or from outside shareholders. By working with a PEG in a family succession transaction, active family members secure operating control and significant equity ownership, while gaining a financial partner for growth. In addition, selling shareholders achieve liquidity to meet personal estate planning and net worth diversification objectives. This type of transaction also ensures that the family business stays in the family and maintains its identity within the community.

Management/Key Employee Buyout. PEG's can partner with key employees

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Common Questions Relating to the Business Sale Process

As a professional business intermediary, we interact daily with business owners and understand many of their concerns. In each issue, we address common questions of business owners relating to the business sale process.

1 *What is the rationale behind adding back Interest and Depreciation when recasting earnings?*

Depreciation is a non-cash expense that is included solely for accounting and tax purposes. Example: a business purchases a piece of equipment at a cost of $100,000 that has an estimated useful life (for tax purposes) of five years. Each year the business deducts or depreciates $20,000 for tax purposes. While this reduces the tax burden, it is not an actual outflow of cash and is therefore added back to arrive at recast earnings. Depreciation that is added back must then be offset by the real or anticipated capital expenditures ("Capex") budget. A sophisticated buyer that is reviewing a capital intensive business will only add back a portion of the depreciation amount after allocating a certain amount for required ongoing items, such as plant equipment, vehicles and computer systems.

Interest Expense is a function of the capitalization of a business and can vary widely from one owner to another. If the business is well capitalized and operating entirely from operational cash flow, there is no requirement to obtain additional funding or leverage finances; and therefore no associated interest expense. Alternately, if a buyer assumes any of the existing loans at closing, the associated interest for those items would be an actual ongoing expense that cannot be added back to cash flow. This is common when an acquirer assumes lease payments relative to equipment that is included in the sale. Typically, the seller will satisfy interest bearing loans from the sale proceeds at closing, thus eliminating the recurrence of an associated interest expense.

2 *What is a common practice for dealing with accounts receivable & payable when selling a business?*

The most common transaction for small and mid-size businesses is an "asset sale," whereby the company will sell substantially all of the assets of the business. It can be advantageous for certain assets, such as cash, cash equivalents and in certain cases accounts receivable, to be excluded from a transaction.

The general rationale for excluding certain assets is that they are generated from sales made by the seller prior to the closing of the transaction. In certain cases the structure is used to increase the transactional yield, while in other instances there can be tax advantages to the seller. Though accounts receivable may be retained by the seller and not included as part of the transaction, the seller should consider this as part of their total transactional yield for selling the business, since these assets will only become "freed up" to the seller upon the sale of the business. Furthermore, a buyer will consider this amount as an additional purchase price requirement because they will have to recapitalize the company to replace the accounts receivable (working capital) retained by the seller. If the seller retains the accounts receivable, the buyer will need to infuse additional working capital to cover the initial 30 to 60 day period with no cash flow.

In larger transactions, it is common for the accounts receivable to be one of the included assets being acquired. This is then factored in as part of the negotiated purchase price. It is typical for the accounts payable to follow the accounts receivable. If a seller is going to retain their accounts receivable for sales made prior to a closing, they will also be responsible for paying down all accounts payable.

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in the acquisition of the company in which they currently play a key role, but do not own. Sellers can receive an all cash price since PEG's tend to not rely on seller financing. Key employees receive a generous equity stake in the conservatively capitalized company while retaining daily operating control. Management has the PEG as a well funded, knowledgeable partner to consult with and help them grow the business. As an experienced partner with a strong track record, the PEG adds financial and management credibility to the employees, which can also help with perception in the marketplace.

Buyout groups have become a major force in the acquisition arena. Buyout groups can also be thought of as strategic type acquirers in certain instances, when they own portfolio companies in your industry or a related area that addresses the same customer base. These buyers may be in a position to pay more than an industry or strategic buyer that does not have this financial backing.

Announcing *Sun Business Valuations, LLC*

Sun Mergers & Acquisitions has formally established a subsidiary, **Sun Business Valuations, LLC**, to focus solely on providing business valuations and appraisals for privately held companies. Sun's Managing Partner, Stephen Goldberg states: "We have always been a best kept secret in providing valuation services and are excited about branding the division to increase awareness of our long-established service. The sale of businesses provides a transactional perspective that uniquely positions us to provide accurate, quality business valuation services."

Sun Business Valuations is a full service business valuation firm providing Attorneys, CPAs, Investment Advisors, Consultants and Business Owners with professional business valuation services. Sun has performed business appraisals for privately held companies in a wide array of industries such as: business services, manufacturing, distribution, retail, construction and financial services. Sun's business valuations are prepared for a wide variety of purposes including: business sales or mergers, partner buy-outs, estate planning, buy/sell agreements, divorce settlements, financing and gifting. Sun Business Valuations, LLC is fully accredited through the American Society of Appraisers (ASA) and is a long time member of the Institute of Business Appraisers (IBA). Sun's valuations have been reviewed and accepted by many highly respected accounting firms; stand up to legal scrutiny; and, when appropriate, conform to IRS Revenue Ruling 59-60. In addition to providing business valuations, Sun offers related litigation support and expert witness services. Please visit us at www.sunbusinessvaluations.com or contact Stephen Goldberg at 201-727-1300 for further information.

Customer Concentration

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industry, which requires that a company making a change in resource will have to regain FDA approval. In the record storage industry, a departing customer may have to pay a significant sum of money to remove their boxes from storage. Existing contracts must be reviewed to become familiar with the triggers and requirements of a change in ownership. In some instances, a purchase of stock is required (as opposed to buying the assets of the company) to preserve these agreements.

Multiple Products or Services. If your company is providing multiple products or services to the customer, the chances that the account will be lost are significantly reduced. In this situation, the co-dependency or your critical importance to the customer's operation presents a solid relationship. The goal is to demonstrate that, while the risk factor exists, the likelihood of losing a key customer is remote.

Gross Sales or Profit. A customer that accounts for a significant percentage of gross sales may be receiving highly favorable pricing and require a disproportionate amount of servicing or additional infrastructure. In these situations, losing this customer may not be that devastating. A customer that represents 30% of gross sales may only account for 20% of the gross profit. If that customer were to leave, the company could reduce personnel and cut other expenses. Illustrating that the loss of this customer is not as serious as it initially indicated, will serve to further mitigate a buyer's concern. In some cases, this analysis results in the seller reconsidering the value and wisdom of retaining certain high volume, low margin customers, irrespective of the business sale.

Earn Out Structure. When dealing with customer concentration issues, the most effective transaction structure strategy is to earmark part of the purchase price as a retention or performance based "earn out," dependent upon retention of a key customer for a fixed period of time following the closing. A seller cannot be expected to guarantee the revenue in perpetuity. At a certain point, responsibility and risk must be assumed by the new owner. Conversely, a seller should be able and willing to effectively guarantee the retention of a major customer for at least 6 - 12 months. A "purchase price adjustment" would be linked to the potential variance of revenue/profit from that major customer. In these instances, it is typical for the seller to maintain relationship management responsibility with this account following the transaction. If this customer were to be lost with the seller overseeing the relationship, a pricing adjustment would certainly be warranted.

Customer concentration issues cannot be avoided and retention of key customers through a transition period will be a key concern of any acquirer. By presenting it in the best light, and by potentially structuring a transaction that will mitigate some of this transactional risk, the probability of a transaction closing and maintaining a fair purchase price will be maximized.

EXIT STRATEGY

Sun Mergers & Acquisitions is a professional business intermediary firm specializing in the confidential sale and merger of privately held businesses.

Sun Business Valuations, LLC provides valuations and appraisals of privately held companies for business owners and their advisors for a variety of purposes.

Stephen Goldberg, the Managing Partner of Sun M&A, is a Certified Business Intermediary, engaged in sales and merger transactions since 1985. He is a frequent speaker and writer on the sale of privately-held companies.

"Exit Strategy" is distributed quarterly, compliments of Sun M&A, to advise business owners and their advisors on topics involving valuing privately held companies, building market value and preparing for an eventual exit strategy.

SUN Mergers & Acquisitions

411 Route 17, Hasbrouck Heights, NJ 07604
800-232-0180 • 201-727-1300

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