

The

EXIT

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## TURNING THE TABLES

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## GROWING YOUR BUSINESS THROUGH ACQUISITION

*The Exit Planner* is dedicated to the owner seeking to exit his business in style. The feature article by Ned A. Minor, however, discusses buying someone else's business. At first glance, this article may seem designed for business *buyers*, but don't be fooled. Acquiring other businesses is a tool that business *owners* use to grow their own businesses.

The operative word is *growing* your business through acquisition, the purpose of which is to increase the value of your existing business. Recall the Exit Planning process discussed in the previous issue of *The Exit Planner*. The first three steps of the seven step Exit Planning process are:

1. To set exit objectives;
2. To determine the value of your business; and
3. To increase the value of the business.

It is this third step that concerns us today.

*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 financial security assured. For most owners then, meeting retirement objectives is a function of having sufficient value within the business to permit their departure.

For those owners who experience a disparity between when they *want* to leave and when they are *able* to leave, an often 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 be to allow you to become a seller sooner rather than later.

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### WHAT'S NEXT

The next issue of *The Exit Planner* will describe the actions you can and should take if, and when, an industry consolidator calls you. Investment Banker, Joseph M. Durnford will describe what consolidators look for and how to cast your company in the best possible light. Don't miss this important article.

# GROWING YOUR BUSINESS THROUGH ACQUISITION

By Ned A. Minor

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 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. But rarely have they covered every base and thought out every contingency in the acquisition process. Recognizing this, they consult a transaction attorney.

At the first meeting with a business owner (whom I 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 business.
2. The buyer, in some manner, has already initiated the acquisition process.
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 own.
5. Typical acquisition targets are either direct competitors or are somehow related to the buyer's industry so that a strategic acquisition makes good 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 lawyer and accountant to maximize the advantages and tax planning opportunities available in this process.
9. Most buyers have not given adequate thought to how they will pay for the acquisition. In the worst case, buyers hope that the seller will finance part of the purchase price by taking back a promissory note. In the best case, the buyers 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" mindset will enable you to identify with and to maneuver around many of the issues that will concern the seller. Let's look, then, at what makes a prepared buyer.

## A PREPARED BUYER:

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

The prepared buyer and his advisors choose the team members who will act as "lead negotiators" both with regard to the financial items (purchase price, sale structure—asset vs. stock and form of payment—cash vs. stock) as well as the 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, your transaction attorney will negotiate the legal items with the seller's attorney. In either case, the lead negotiator acts as a buffer between you and the seller. He or she protects you 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 you the time you need to make thoughtful, informed decisions. Meanwhile you can concentrate on developing a working relationship with the seller (business person to business person). When difficulties arise (notice I did not say "if") you will be in a position to smooth things over.

In addition, the lead negotiator will:

1. Know what questions to ask,
2. Recognize which points he is likely to win and those points he will probably lose or compromise,

3. Keep the deal moving at a reasonably quick pace,
4. Maintain credibility at all times.



→ **NED A. MINOR**

### 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:

1. Conducting a thorough legal Due Diligence;
2. Analyzing the structure of the deal;
3. Negotiating and drafting legal documents;
4. Analyzing the tax ramifications; and
5. Making sure all of the "i's" are dotted and the "t's" are crossed.
6. But by far the transaction attorney's most important role is to keep all advisors and all parties focused on one objective: CLOSING THE DEAL. No personalities, egos, or conflicting agendas should be allowed to delay or to derail closing.

This last task requires finesse on the part of the transac-

tion 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:

- To become more diversified;
- To reduce competition;
- To increase market share;
- To attain economies of scales;
- To expand geographically;
- To establish strategic alliances;
- To achieve greater leverage with vendors;
- To add new lines of goods or services; and
- To provide enhanced growth opportunities for employees.

Actually, this list could be just as easily titled "Benefits of Growth Through Acquisition."

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, on a time frame that you establish...the goal of Exit Planning.

If growing through acquisition fits your Exit Plan then, what criteria should you establish for choosing an acquisition target? Should you look for a good, strong, solidly performing company with a consistent history of growth and earnings and with upside potential? (Yes!) Or, should you look for a turnaround situation? (Be careful!)

A turnaround is typically a company that has been consistently under-performing, 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 brain damage.

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 perhaps an 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.

Once a viable seller is identified and you have not retained an investment banker, 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 it kicks off the negotiation process.

In the "typical" transaction, the business owner's accountant or transaction attorney then takes the following actions. First, he contacts the acquisition target by letter stating that he or she represents a serious and qualified buyer who has identified his company as one that fits the client's acquisition criteria. Second, he indicates that he will call the target again soon to discuss this 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 buyer on a business person to business person basis. This will enable you to learn more about the business, its operations, customers, vendors, employees and growth potential. Business owners love to talk about their companies. (You do, I do.) Encourage this weakness. The more you know about the seller as a person and as an entrepreneur, the more informed your acquisition will be.

Further, your role as buyer during the acquisition process is to tell your story. You may want to acknowledge that the seller's company fits your criteria, and to 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 this 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 need for confidentiality. All sellers are justifiably paranoid concerning confidentiality. Put yourself in his 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 to the information exchanged between them. It also prohibits the buyer from using that 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 should:

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 satisfied 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, and
6. Make clear that the Letter of Intent is non-binding except for certain provisions.

Once the Letter of Intent has been signed, your financial advisors will conduct a 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.

Concurrently, legal counsel will conduct a full and complete Due Diligence of all legal matters affecting the company. During this 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 if 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 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, over a period of a few years, most of the purchase price in some form. 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 one hundred percent of the purchase price in cash at the closing. In today's market, sellers of good performing companies can command and receive either a full cash or stock buyout.

As previously mentioned, a prepared buyer has his financial package in order. You need to determine, prior to identifying the target, what your true financial capabilities are. You should know how much equity you can contribute, and how much you can borrow against your company's assets as well as your personal assets (if you are willing to put them into play). The missing piece is always: how much will you be able to borrow for the proposed acquisition? Knowing your own financial capabilities will dictate whether or not you must ask the seller to carry back part of the purchase price. Keep in mind that requiring the seller to act as your lender may knock you out of the running. In this current "Sellers' Market," there are far more financially qualified buyers than there are good companies for sale.

### **NEGOTIATING POINTS**

Clearly the purchase price, the deal structure and the 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. As such, 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. The Warranties and Representations include but are not limited to the following:

1. Corporate Standing. Is the business in good standing in the jurisdiction where it is located?
2. Authority to consummate the deal. Can the seller do what he says he's going to do or does he need the consent of a third party?
3. Capitalization. Does the seller own his shares free and clear?
4. Financial Statements. Is the financial information provided true and accurate?
5. Absence of Changes. Has the seller conducted business in substantially the same way in the past?
6. Contracts. Have you seen all of the contracts that bind the seller? Has he defaulted on any?
7. Title. Does the seller have free and clear title to the assets he's selling?
8. Property. Has the seller complied with his lease? Is he in violation of any zoning rules?
9. Penalties or threatened litigation. Is the seller in compliance with all applicable laws and does he 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 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 upon 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.

## 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 upon period of time in order to effect a proper transition of the company. If you do want the seller to become a permanent employee, then a well thought out 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.

The general rule of law in Colorado is that Covenants Not to Compete are not binding. That said, 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, and therefore is valid and binding so long as it is reasonable in geographic scope and duration of time. (Please check with an attorney in your state about 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.

## THE FINAL WORD

Don't be a "do it yourselfer." In today's sellers' market you must be organized and prepared to move swiftly. Too often, frustrated buyers first try to represent themselves and then complain to me that just when they thought they had a deal, they were outbid by a third party, typically a publicly owned consolidator. (The next issue of **The Exit Planner** will describe consolidators and what to do when they call you.) During our post-mortem 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 as well as the transaction itself.



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*We, at The Exit Planner, are happy to answer any questions you have about articles that appear here. We also appreciate suggestions from readers about the Exit Planning topics that they wish to see addressed. We welcome your comments regarding our newsletter. You can address your questions, comments or suggestions to: John H. Brown, President, Business Enterprise Institute, 650 S. Cherry Street, Suite 1100, Denver, Colorado 80222 (303) 321-2242.*

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