The EXIT Planner

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WHAT'S INSIDE

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GODZILLA THE CONSOLIDATOR

When a consolidator first calls or approaches you expressing an interest in acquiring your business, your reaction will likely be mixed. On one hand, you will be pleased and excited that a Big Player in your industry is considering your business for acquisition. On the other hand, you may be wary that the consolidator will turn out to be "Godzilla" and summarily trample over you, your business, and your employees.

Consolidators can appear to be all-powerful and all-knowing, but they do not hold all of the cards. As the ensuing article will demonstrate, there is a proven strategy you can adopt so the consolidator who calls you is just one of many players at the table instead of the dealer who makes all of the rules and deals from a stacked deck.

This issue of *The Exit Planner* discusses what to do after the consolidator calls. I want to spend a moment describing what you and your business need to do **before** the consolidator calls—and how that call can fit into your overall Exit Plan.

The first and most important step of the Exit Planning process is to determine your exit objectives:

- When do you want to transfer your business?
- How much money do you need to achieve financial security when you transfer your business?
- To whom do you wish to transfer your business?

Determining these exit objectives **now** allows you to respond to the consolidator on your terms—rather than simply reacting to an unsolicited offer from a consolidator.

For example, calculating the amount of money you need from the sale of the business to reach your security objective is crucial. **How** you determine that sum of money was addressed in the previous issue of *The Exit Planner*. I strongly suggest you work with your financial advisor to set your financial objective(s). Knowing what you want and what you need, enables you to proceed along a path dictated by your objectives, not the consolidator's.

Similarly, you may have set as an objective the desire to continue actively working with the business for several more years. If so, you may regard the opportunity to sell now to a consolidator as limiting or defeating that objective. but that need not be the case since most consolidators view positively your desire to run and manage the existing operation and perhaps other businesses to be acquired in the future.

Finally, the third objective, "who to transfer the business to," needs to be thoughtfully analyzed, sooner rather than later. Obviously, if the consolidator wishes to acquire your business, it will not be transferred to family members or to key employees. If you have always dreamed of having your children, or perhaps your employees, own and control your business, then don't spend valuable time, energy and money investigating whether you should sell the business to an industry consolidator.

So, when Godzilla The Consolidator calls upon you, or if you wish to call upon the consolidators in your industry, proceed with confidence that you are the dealer in this card game, not the consolidator. (Assuming, of course, that you know what you want to accomplish—by setting your exit objectives—and how you can accomplish it.) If your goal is to sell your business under the best possible terms, conditions and price, then you will want to employ the proven approach discussed in this issue of *The Exit Planner* by investment banker, Joseph M. Durnford, of J.D. Ford & Co.

WHAT TO DO WHEN THE CONSOLIDATOR CALLS

By Joseph M. Durnford and Steven D. Neumann

What do travel agencies, commercial print shops, florists, temporary staffing companies, office products, optometrists, ambulance companies, and funeral homes have in common?

Each is in an industry that is currently being consolidated by large, well capitalized companies. And these are only a few of the industries currently undergoing rapid consolidation. A complete list of industries would also include: telecommunications, financial services, metal recycling, plumbing, heating and air conditioning, waste handling, towing services, limousine services, pallet manufacturing, and building products distribution. In short, just about any industry you can think of is being consolidated. Many of these industries have historically been referred to as "Mom and Pop" industries served by private companies in local markets.

Fortunately, or unfortunately, depending on your perspective, Wall Street and many of its wealthiest players have taken notice of the tremendous wealth that can be created by consolidating these highly-fragmented industries. The players in the consolidation game include such well known names as billionaire Wayne Huizenga, of Waste Management, Blockbuster Video, and Florida baseball fame, as well as Paul Allen and Michael Milken, the co-founder of Microsoft and the "Junk Bond King." The line-up of consolidators also includes more recent additions such as Jon Ledecky, a thirty-something entrepreneur who built U.S. Office Products from $0 to over $3.5 billion in revenues in three years, by completing nearly 300 acquisitions. (That's almost two acquisition per week—non-stop.)

These consolidators are highly creative and aggressive and in some cases have access to unlimited capital. For example, Jon Ledecky recently formed "Consolidation Capital, Inc." and raised over $500 million in a public stock offering at its inception. In other words, he raised $500 million before he had identified which industry or which companies he intended to buy. Wall Street was betting solely on Mr. Ledecky's track record at U.S. Office Products.

Consolidators typically pursue a consolidation either as a "buy and build" or as a "roll-up" which are sometimes referred to as "poof companies." A buy and build consolidation strategy is generally started when an experienced CEO teams up with a Leveraged Buyout Private Equity fund to buy a "platform company." The platform company is usually an industry leading company with revenues in excess of $50 million. The CEO, together with the private equity group, then seek to build a much larger company by making numerous acquisitions. Buy and build acquisition strategies are usually executed using a combination of debt and equity with the buyer paying cash for acquisitions. The promoters of the buy and build strategy anticipate that they will repay the debt and increase equity value by taking the consolidated company public at some future date.

The roll-up is a relatively new phenomenon born of the frustration felt by many corporate acquirers who dreamt of gobbling up a slew of "mom and pop" businesses, using public money, while avoiding the goodwill expense associated with the acquisitions. These roll-up artists also want to hit the ground running with some critical mass. Promoters of the roll-ups realize that the quickest and least expensive way to consolidate a fragmented industry that does not have a natural leader already in place is to create one. So, the promoters of roll-ups create a large public company by acquiring five or six private companies and simultaneously taking the acquiring company public. These "Poof Companies" instantaneously create a new industry leader that can use publicly traded stock to acquire more companies. Roll-ups are so popular on Wall Street that Montgomery Securities has created the "Consolidator Index" to track the market performance of these companies. As a group, the companies in the Consolidator Index have shown very strong performance over the last three years. Since the beginning of 1995 (the first full calendar year following 1994's six consolidator IPOs), the stock value of these consolidators has risen 150 percent, substantially outperforming most market measures, including NASDAQ and the S&P 500.

Essentially, both the buy and build strategy and the roll-up strategy have the same objective: to consolidate highly-fragmented industries. To accomplish this objective the Consolidators must constantly be on the look out for acquisition opportunities. The Buy and Builders are under constant pressure to invest more private equity and build shareholder value in anticipation of a public offering. The Poof Companies are under pressure from Wall Street analysts who expect the Poofers to acquire numerous companies in a short period of time. If the Poofers fail to meet Wall Street analysts' expectations, then the stock can nose dive. To accomplish their goals of acquiring multiple companies quickly, the Buy and Builders, and the Poofers, (hereafter collectively referred to as the "Consolidators") build teams of professionals whose sole job it is to buy companies. Therefore, owners of well-run privately held companies should expect to receive a call from a Consolidator.

The good news for entrepreneurs is that the Consolidators

are bringing new money, and lots of it, to industries that historically have not provided small businesses with the opportunity to sell at premium prices. The Consolidators, with their Wall Street funds, well-trained managers, and aggressive growth plans, have enabled many entrepreneurs to cash out of their companies, take some chips off the table and still remain involved in the management of their businesses. In some cases, but not all, the Consolidators have further rewarded those entrepreneurs who took stock as part of the deal, because of significant share price appreciation.

The purpose of this article is to tell you what you, the entrepreneur, can do to take full advantage of the current market opportunity to sell your company for a premium price, while avoiding some of the downside risk associated with giving up control. In essence, "What to do when the Consolidator calls."

JOSEPH M. DURNFORD

WHEN THE CONSOLIDATOR CALLS

Consolidators are in the business of acquiring privately held companies. They are acquisition machines that are very effective at purchasing companies at favorable prices. Often the people in charge of these companies have many years of experience in mergers and acquisitions, have advanced business and law degrees and can be characterized as a "Dream Team" in the acquisition game.

My company, JD Ford & Co., has been involved with several Consolidators in numerous industries. During the past 12 months, we have represented several service-oriented businesses—including plumbing and heating companies, drain cleaning companies, travel agencies, contract manufactures, floral distributors, and commercial printers, all of whom have sold to a "Consolidator."

The lesson to be learned from these clients is that when a Consolidator calls, it may be an opportunity for you to gain liquidity for your company and to gain personal financial independence. Based on our experience, when the Consolidator calls, there are several rules business owners must follow in order to ensure that they receive the highest possible purchase price for their companies, and increase the opportunity for successfully closing a sale.

The rules outlined in this article put you, the business owner, in control of the sale process. Together, the rules enable you to create a controlled auction environment, with multiple buyers bidding for your company. This competitive sale process will ensure that you sell your company under terms and conditions that are acceptable to you, and not those dictated by a Consolidator.

It is important for you to understand that in nearly all cases there is more than one Consolidator in each industry. Typically, there are three or four Consolidators vying for dominance within an industry. For example, in the office products industry the chief Consolidators are Corporate Express, US Office Products, Office Depot, Office Max and Staples. In the HVAC industry Service Experts, Group Mac, and American Residential Services are competing to be the industry leader.

Recently, an industry Consolidator approached one of our clients to join their roll-up. This was not the first time our client had been approached by someone seeking to buy his business. It was, however, the first time that the potential buyer seemed to be offering something other than a small down payment with a long-term note that he would carry. Our client thought that this was a once-in-a- lifetime opportunity, and that there were no other "real" buyers for his business. The deal so appealed to our client that he was seriously considering signing the letter of intent that had been presented.

Although the deal appeared to be very generous, there were certain aspects of the proposed transaction that our client did not understand. He also felt uneasy about how slick the deal seemed, and sensed there was more to the deal than met

the eye. So, rather than succumb to the buyer's instructions that he sign the letter of intent within ten days or be "left out," he came to see us. He asked us to review the transaction and advise him on his options.

After reviewing the terms of the proposed transaction we discovered that our client's instincts were correct: there was more to the deal than met the eye. The proposed transaction would have paid our client the purchase price one-third in cash, one-third in preferred convertible stock, and one-third in common stock of a "not yet" public company. The provisions of the preferred stock and the common stock did not provide our client with any additional cash for at least two years, and there was no guarantee that the stock would ever become liquid in the public market. There were also provisions in the transaction that would have required our client to repurchase the company, if the Consolidator was unable to execute its public offering. Furthermore, due to the unusual structure of the deal our client would have incurred significant tax liability on the full purchase price, even though only one-third of it was paid for in cash.

As a result, our client wanted to change the deal, but did not want to lose the opportunity to sell his company. We advised him that our research indicated that there were at least two other Consolidators in his industry and that he should solicit offers from them as well. Having only ten days to respond to the first buyer, we had to move fast.

Our first task was to assemble the advisory team. This team developed a selling strategy as well as the sale objectives. We then prepared an abbreviated selling memorandum, contacted the other two Consolidators, orchestrated meetings between our client and senior executives from each of the other Consolidators, and negotiated with both of them.

After the first round of negotiations it was apparent that one of the two was a perfect fit for our client, in terms of transaction structure, price terms, and management philosophy. We negotiated with this Consolidator until midnight on the ninth day. On the morning of the tenth day we contacted the first buyer with the information that its offer was unacceptable to our client, and it would need to be substantially revised to win the bidding for our client's company. This Consolidator was stunned at the turn of events, and hurriedly put together a better offer. After further negotiations with both parties, our client ultimately accepted the second Consolidator's offer. This offer enabled our client to gain liquidity of 100 percent of his investment within 90 days of closing at a price that was 25 percent greater than what had originally been proposed by the first and "only" buyer. After taking taxes and advisory team costs into consideration, our client still walked away with an additional $1 million. After closing, he said that the past ten days had been the most profitable and enjoyable of his business career, and he was glad that he hadn't run off with the first buyer.

EP RULE ONE:
DON'T RUN OFF WITH THE FIRST BUYER

There are usually several different companies that are actively consolidating an industry. The first Consolidator to call may not offer you the highest price or the ideal transaction structure. Therefore, you should contact an investment banker to learn more about consolidators in your industry.

Your investment banker will quickly assess your alternatives, and will help you craft a negotiating strategy that will maximize the opportunity to sell your company. Often, if not always, the strategy will include coordinating a controlled auction for your company. By creating competition among several buyers, you, as the seller, will be in control of the sale. The transaction that you ultimately accept will likely be the one that comes closest to meeting your individual objectives. Finally, you will exit your business knowing that you have received a full and fair price for your company.

EP RULE TWO:
ASSEMBLE YOUR OWN DREAM TEAM

Before a confidentiality agreement is signed, the seller of a business should organize a team of professional advisors. Contact your attorney, CPA and an investment banker. Professional advisors play a critical role in protecting a business owner's interest during the sale of a business. Your attorney prepares and reviews transaction documents, such as the purchase agreement, lease agreements and employment agreements. Your CPA coordinates the financial due diligence that will be performed by a potential purchaser, and advises you on the tax implications of a transaction.

An investment banker is the financial professional who guides you through the transaction and improves your odds of hitting a financial homerun. An owner who is contemplating selling to a Consolidator must realize that consolidators are professional acquirers. They buy hundreds of companies each year, and they are very skilled at negotiating the value of a business and structuring a transaction in their favor. Given the skill of the buyer, it is to your advantage to hire a pro-

fessional to represent you on equal footing. I liken it to bringing in a "ringer" to help you win the game. An investment banker will advise you in the negotiating process, determine a reasonable market value for your business and will position your company to receive the highest possible purchase price. The investment banker will also improve the probability of closing the deal, because he is experienced at overcoming obstacles during negotiations and speaks the same language as the Consolidators.

EP RULE THREE:
OBTAIN A SIGNED CONFIDENTIALITY AGREEMENT

A confidentiality agreement should be signed by the Consolidator before any information is exchanged. The confidentiality agreement will protect you from the buyer disclosing confidential information about your business or from disclosing that your business is for sale. Keep in mind that if a Consolidator does not acquire your business there is a good chance that it will acquire one or more of your local competitors. Also, be sure to have your attorney review any changes made to your confidentiality agreement by the buyer. Provisions may be added to the agreement that will prevent you from negotiating with any other parties.

EP RULE FOUR:
UNDERSTAND THE BUYER'S VALUATION METHOD

Many Consolidators are publicly traded companies and are generally able to pay a higher price for your business. However, they will be unwilling to pay a price that would be "dilutive" to earnings per share. If you are to receive the highest possible price for your company, it is important that you understand the valuation formulas that are used by Consolidators in your industry.

In addition, you should also take note of how the Consolidator will account for the transaction. There are two accounting methods that apply to mergers and acquisitions—"pooling of interests" and "purchase accounting." It is important to understand which accounting treatment is being used. The accounting treatment will have a significant impact on the valuation of your company because the "purchase" method creates goodwill expense which reduces the Consolidator's future earnings, whereas the "pooling" method does not.

EP RULE FIVE:
RECAST FINANCIAL INFORMATION

Many small business owners prepare their financial statements on a cash basis with a desire to reduce their tax liabilities. As such, the net income on a company's financial statements by be substantially understated.

Common areas that are understated and that may not reflect the economic reality of the company are as follows:

Inventory. Usually small business owners immediately expense a large portion of all inventory. If that is the case, inventory on the balance sheet will be understated and cost of goods sold will be overstated. The result is a lower net income and likely a lower valuation.

Prepaid Expenses. In addition, small business owners immediately expense any prepaid items such as insurance premiums. This would have the effect of decreasing net income and would likely lower a company's valuation.

Excess Owner's Compensation. Many small business owners have the luxury of taking salaries in excess of market compensation. If an owner sells his business to a Consolidator, the owner's salary will likely be adjusted to reflect reasonable market compensation. As such the differential must be recast into the financial statements in order to get a true picture of the financial condition of the company.

These are just a few examples of possible areas of a company's financial statements that may need to be recast. An investment banker will work with you to gain a deeper understanding of your operations and fully adjust the financial statement to reflect economic reality. Keep in mind, every dollar increase in your company's earnings that is a result of recasting your financial statement could possibly increase the purchase price by a multiple of four, five or six times. For example, if there are adjustments that increase earnings by $20,000, the resulting increase in purchase price could be anywhere from $80,000 to $120,000. Do not rely on the Consolidator to help you identify all of the potential add backs; it is not in his best interest to do so.

I suggest that, if you are at all interested in selling your company to a Consolidator, you have your financial statements audited by a respected CPA firm. Audited financial statements make you a more attractive acquisition candidate, and will enable the transaction to move forward quickly.

EP RULE SIX:
ASSESS STRATEGIC AND FINANCIAL FIT

It is important to assess the strategic fit your company offers the Consolidator. If your company is one of the leaders in your industry or your region, your company may command a premium price. It is your responsibility to identify the strategic reason why your

company should command a premium price. It is also important to demonstrate the unique benefits that your company can bring to the Consolidator's operation and the financial rewards to be gained from owning your business.

EP RULE SEVEN: PREPARE DUE DILIGENCE

If your company is purchased by a Consolidator, it is likely that your operations and financial records will be under a great deal of scrutiny during the due diligence period. We recommend that the due diligence process be coordinated by your investment banker. This will allow the investment banker to control the document exchange process and maintain control over the flow of information.

Consolidators are usually public companies and as such are under careful review by the Securities and Exchange Commission. Therefore, it is essential that all of your records are in good condition before the due diligence period begins. Your investment banker should work with your accountant and your attorney to review all of the accounting and corporate records before the buyer begins his due diligence. The review of these documents will allow your advisors to discover and resolve any issues that may be of concern to a potential buyer before the documents are actually reviewed by the buyer.

THE FINAL WORD

Due to the robust nature of the current merger and acquisition market, it is only a matter of time until someone with connections to Wall Street identifies your industry as one that is ripe for consolidation. When this happens, if it hasn't already, you should expect a call from someone who wants to buy your company. Answer this call with confidence; you are now prepared to win the consolidation game, because you know "What to do When the Consolidator Calls."

Joseph M. Durnford is an investment banker and president of J.D. Ford & Co. in Denver, Colorado. For more than ten years he has helped owners of privately held companies reach their financial goals through acquisition, sale, or merger. Mr. Durnford can be reached at 303/333-3673.

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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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