

# PRIVATELY HELD

C O M P A N Y

the report on transaction issues

## BUSINESS ACQUISITIONS, LTD

*Since 1986, Business Acquisitions, Ltd. has successfully completed over 700 transactions. We proactively represent our clients throughout the entire selling process including valuing their business, implementing a confidential marketing strategy, negotiating the transaction and completing the sale.*

### The Anatomy of a Deal

The following might be a subtitle for this true account of how one deal was put together:

***“In spite of everything, you need only one buyer— the right one!”*** (Although the details are factual, names and financial data are fictional.)

The company (“ElectroCo”) has carved a niche in a billion dollar industry. It manufactures proprietary electronic products and is owned by a private equity firm interested in selling for liquidity reasons. At the beginning, the private equity group retained an intermediary firm (“United Associates”) to take the company to market. The goal was to have it sold by the end of the year.

ElectroCo had annual sales of about \$12 million, gross margins of 50 percent, an EBITDA of \$1.8 million (15 percent) and a reconstructed EBITDA of \$ 2 million. It had been growing over the previous 10 years at a 10 percent rate and had always been profitable. It had a diverse customer base split about equally between end-users and OEM accounts. However, the seller wanted to set a very aggressive full price, with all-cash in a not-so-vibrant M&A market.

On the plus side, the seller was cooperative and provided any information United needed. It also had audited statements, conservative accounting and instant monthly statements. ElectroCo was also, in addition to these factors, on the verge of getting a substantial amount of new business.

In preparing to take the business to market, United came up with a basic game plan. Direct competitors were eliminated from the buyer search for confidentiality reasons. Synergistic buyers were targeted—either because they served similar markets or utilized similar manufacturing methods. United also contacted selected private equity groups and other intermediary firms.

More specifically, United planned on creating a list of 100 potential buyers. A buyer was defined as an entity that had signed a Confidentiality Agreement, had been pre-approved by the seller, and therefore, had been sent an Offering Memorandum. United anticipated 15 written Term Sheets leading to five Letters of Intent which, hopefully, would lead to the best deal. United was not sure that they could sell the business at the multiples asked by the seller. However, they succeeded, and that success was to be based on the following:

1. Preparing a thorough and compelling Offering Memorandum and pointing out the positive future prospects. This required the complete cooperation of ElectroCo’s management team.
2. Developing a complete list of the possible buyers both in the U.S. and abroad.
3. Contacting the buyers to see if they would be interested in the company, but still maintaining confidentiality.
4. Administering all of the potential buyer activity and sending the Offering Memorandum to the appropriate parties.

## IN THIS ISSUE

- The Anatomy of a Deal
- Buyer Types
- Representations and Warranties

*Continued on next page*

## The Anatomy of a Deal (continued from front page)

1. Following up with all prospects who received the Offering Memorandum to arrange facility tours with the serious prospects.
2. Setting time frames for expressions of interest, term sheets, and fielding questions from the serious prospects.
3. Making sure that complete confidentiality was maintained and that any future confidentiality leaks did not occur.
4. Constantly reminding ElectroCo's management to stay focused on maintaining sales and profit goals.
5. Maintaining communications with both the buyers and ElectroCo's lawyers and other outside advisors.

United was able to develop a list of 85 possible acquirers; however, five would not sign the Confidentiality Agreement.

Buyer Type	Number of Buyers
Strategic	45
Some Synergy	20
Private Equity Groups	20

### Buyer Types

The **strategic buyer** is one engaged in a similar or related business to the one being purchased. Generally, the strategic buyer is willing to pay the highest price since it provides a quick entry to a related business. Buying a business is much easier than trying to replicate it.

The **competitive buyer** offers a lot of synergies that can reduce costs and perhaps increase market share – which also obviously reduces competition. However, this is a less popular type of buyer because sellers are usually reluctant to approach the competition.

The **financial buyer** brings little, if any, synergy to the deal. However, these buyers do bring financial knowledge and use it to increase the profits of the business. They generally make changes and work to increase the value in order to sell it at a profit in five to seven years. The financial buyer almost always insists on owning 100 percent of the acquired business.

The **overseas buyer** can be difficult to find, and usually wants to acquire larger companies. This type may look at a smaller firm if they feel that it provides an entry to the U.S. market, and will pay well for such a company.

A **customer, vendor or supplier** is also a possible acquirer, but vertical integration is not perceived as a viable acquisition strategy today.

Of the 85 possible buyers, 15 were companies or divisions of firms with annual revenues of \$1 billion or more. 12 of these 15 were foreign or owned by foreign companies. ElectroCo chose not to deal with four of the buyer firms due to negative industry knowledge. Two of the buyers were individuals that had financial backers. Four buyers were just “bottom fishing.” Three of the 85 decided not to move forward due to the events of September 11. One buyer only wanted to acquire assets, not the stock, of ElectroCo. Interestingly, eight of the 85 firms had previously talked to ElectroCo about a possible merger or acquisition.

Of the buyers who elected not to proceed or move forward, the majority felt that acquiring ElectroCo was just not a good fit. Some of the other reasons why other buyers decided not to continue were:

- ◆ Management was too thin.
- ◆ Since ElectroCo was a good company, the price would most likely be too high.
- ◆ The buyer purchased another firm.
- ◆ One potential acquirer was acquired itself.
- ◆ The buying company was having its own internal problems.
- ◆ The buyer wanted to move the company; this was unacceptable to the seller.

After all of this, United Associates arranged five visits for acceptable buyers – the target number. Overall, United received:

Term Sheets	4
Verbal Offers	2
Letters of Intent	4

Of the five buyers who visited the business and met with ElectroCo's management, two wanted to acquire the company. These were the best prospects. There were also two other firms, held in abeyance, in case one of the other two didn't work out. One of the original two and ElectroCo's preferred acquirer offered the desired price and terms. The buyer was:

- ◆ A public company that wanted to grow through acquisition.
- ◆ One with a synergistic product line.
- ◆ Unlike some of the private equity groups, not totally focused on the financial aspects.
- ◆ One with an appreciation of ElectroCo's product lines, its technology and the company's potential.

United Associates started with 85 possible buyers. The final list came down to just a few. ElectroCo was not a company for just anyone. Despite all of this, United got the deal done – proving once again, that you need only one buyer – the right one

## Representations and Warranties

Both parties and their advisors must understand that Representations and Warranties are not a measure of anyone's honesty, sincerity or integrity, but a method of allocating some of the risks inherent in any transaction. After all, buyers and sellers are entitled to all the benefits of their bargain – nothing more and nothing less.

In almost any sale of a business, the seller makes certain representations. These Representations and Warranties may focus on various legal, financial or environmental aspects of the sale such as: undisclosed liabilities, pending litigation and tax issues. Their purpose is to insure that the seller is truthfully and accurately representing the business and warranting that none of these issues will impede the closing or impact the new ownership. The purchasing entity also represents and warrants, for example, that it has the financial capability to purchase the business.

These representations and warranties are usually included in the final agreement between the buyer and the seller. They can be as simple as the seller warranting to the buyer that there is a clear and marketable title to the business being sold. They can also be a lot more complicated. For example, they may not only contain a warranty or representation, but also provide for a remedy if things aren't as stated or certain future events happen. These are much more important in a stock sale than one of just assets. In the stock sale, the buyer is assuming all of the outstanding issues, risks and, any future problems. The seller might warrant that there is no pending litigation and then a disgruntled customer files a post-closing lawsuit. The final agreement might state that an agreed-upon dollar amount would be set aside to cover such contingencies. This remedy is known as an indemnification. The purpose of an indemnification is to provide a solution to a breach of the representations and warranties

Representations and warranties should be discussed and agreed upon in the early negotiations of the sale. These early discussions can clear up future misunderstandings and provide a safety net for both parties. There is probably little point in continuing negotiations if the representations and warranties can't be mutually agreed upon at the outset. Intermediaries generally prefer to get agreement on them prior to a Letter of Intent being prepared. From a seller's standpoint, the company should not be taken off the market prior to a general understanding of the Representations and Warranties.

They are one of the most important aspects of any final agreement. The buyer obviously wants to have as many of them, and as broad in scope, as possible. They create a sort of built-in insurance policy. The seller, on the other hand, would like there to be none, or as few and as restricted as possible.

Problems can develop when the buyer, for example, inserts among the representations and warranties, an item that is open-ended or beyond the seller's control. For example, the seller warrants that there are no equipment leases or equipment rental agreements other than described in Schedule F. The buyer doesn't want to be responsible for any equipment agreements that have not been mentioned. However, the seller wants to limit the company's exposure. Keep in mind that in privately held companies, the owner is usually responsible for any indemnification of the representations and warranties, so he or she is very concerned with them. The seller's lawyer might limit the exposure to a dollar amount along with a time period – say three years. Or, as is most common, the buyer agrees to absorb any of the leases up to a dollar amount, anything over which the seller must cover. This means that if some equipment leases do turn-up after the closing, assuming that there has not been any fraud or deception, the method of handling them has already been covered in the agreement.

This time period on the Representations and Warranties is a big concern for sellers. The time periods for the Representations and Warranties surviving the closing can be a deal-killer in the seller's eyes. How long should a seller be responsible for them? Obviously, this is a critical area and has to be carefully negotiated between the parties. Some Representations and Warranties that might survive the closing would be matters of litigation, insurance and employee issues. Today, an important post-closing issue can be the intellectual property that may be included in the sale. The buyer entity wants to protect itself from any attack on the ownership of the intellectual property, as it may be a key ingredient of the acquisition. Placing a cap on the dollar amount that the seller and/or his or her company is responsible for and placing reasonable time frames on this section of the agreement can usually resolve this sensitive area.

Sellers often want to couch their Representations and Warranties by using the term "material" in them. In other words the defect must be material to be considered for any type of remedy.

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## Representations and Warranties (continued)

Some sellers even want to limit their exposure by stating that the representation is to the sellers' best knowledge. Experts feel that the buyer is buying the business and anything that makes the deal riskier threatens the sale. The seller's claim that to the best of his knowledge there is no other litigation, except what has been revealed, doesn't provide the buyer the protection that he or she needs. Since the words "material" or "sellers' best knowledge" might be considered vague or ambiguous, placing dollar limits can usually resolve them.

What all this means is that the Representations and Warranties are a big part of the deal. They should not be left to the last. Many sales have fallen apart because a Representation or Warranty and Indemnification were just not acceptable to the seller, or to the firm's board of directors. The buyer's due diligence should uncover many of the issues that will be subsequently incorporated in the agreement as Representations and Warranties, and be addressed prior to the drafting of the agreement. The drafting of them should be left to the pros.

Too many deals have fallen apart, or been delayed, because the buyer or his advisors decided, at the last minute, to insert a "surprise" representation or warranty, that the seller not only did not agree to, but had not even seen – causing the seller to become disillusioned with the buyer.

Representations and Warranties should be discussed early in a transaction, perhaps be part of the deal structure items. And, any changes made after the due diligence period should be disclosed (or proposed) well before the final draft of documents is circulated.

*Note: The above article is not intended to provide legal advice. It is designed merely to offer some insight into the subject of Representations and Warranties. For more information, the reader is advised to consult an attorney, intermediary or other competent advisor.*

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