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BUYING AND SELLING BUSINESSES - SMALL
COMPANY ACQUISITIONS IN VIRGINIA

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I. Overview

A merger or acquisition represents a major challenge to the parties involved. The decision makers on both sides of the transaction must absorb a significant amount of technical data from internal and external experts, decide an optimal course of action, and successfully negotiate this result, usually within severe time constraints. Essential steps often include:

- . Preacquisition Review
- . Determining the Purchase Price
- . Financing the Acquisition
- . The Business Plan
- . Postacquisition Integration

In addition, there are certain actions that a seller can take to "package the company for sale."

II. Preacquisition Review

Once you find a company that appears to be the right fit, how do you determine if it is right for you? How do you avoid the disaster of a company that is dressed up for sale, and sold hard, based on an unrealistic history and potential?

These bad situations can nearly always be avoided by good business planning, patience and doing your homework during a preacquisition review.

Such reviews are normally performed in two phases: First, in connection with developing the bid proposal, and second, as part of a due diligence review once a letter of intent or purchase agreement has been signed.

Make a site visit to the corporate headquarters, and to as many branch locations as possible. Look not only at accounting issues, but also at how the operation works.

Perform as much research as possible before the site visit so your questions can address the industry's specific risk issues, its customers and other aspects of running the business.

Such information is available from offering statements, SEC filings and industry publications -- all are helpful in identifying potential issues and problems.

The issues you should research include:

- . General background of the business.
- . Overall industry conditions and competition.
- . Operations, including inventories and costing.
- . Overhead, selling, and general administrative expenses.
- . Financial considerations, which will encompass financial data, capital structure, management, taxes and risk management.
- . Management style and practices.
- . Research, development and engineering.
- . Compliance with generally accepted accounting principles.
- . Status of pension and retirement plans.

Once the central issues have been identified, company management should be given the opportunity to respond to questions arising from the site visit. The response should then be confirmed through independent sources, if possible.

Market studies performed by industry analysts may support or refute the management's statements on the company's market position. Any projections provided by the management should be evaluated in light of the most recent financial information available.

Other sources of information about the company should also be reviewed. There are many data based on specific industries and trends, for example. Another source is any

internal operating and financial analysis provided to management. Internal and external audit reports, management letters and tax returns should be read. Also, leases, employment agreements, employee benefits plans, minutes, contracts and documentation relating to any litigation can provide extra information about the company's future.

The skill and knowledge of the present management should be evaluated. Indeed, management should be polled to determine whether key people will make the transition or whether the new owner will need to replace top executives.

Once the initial study is completed, all information must be compiled and condensed so that the most pertinent issues can be identified.

III. Determining the Purchase Price.

Estimated fair market value (FMV) may be substantially different from the final transaction price. The process of approximating FMV and the expected transaction price has become increasingly difficult as more and more diverse players with different objectives and perspectives enter the mergers and acquisitions arena.

In addition to the FMV that is established by mechanical valuation techniques, the determination of a purchase price involves consideration of a variety of factors which may vary depending on the characteristics of the target company and the objectives of the buyer and seller.

For example, factors such as the goal to obtain valuable trade names, the desire to take control of another entity or the acquisition of an increased market share for a particular product may affect the negotiated purchase price.

A. Valuation Techniques

No single technique will result in the determination of value, but rather, these techniques combined provide both the buyers and sellers with a range of values to assist them in arriving at a mutually agreeable purchase price.

The more commonly used valuation techniques are:

- . Discounted Cash Flow Technique (DCF)
- . Market Multiple Technique
- . Transaction Multiple Technique
- . Liquidation Valuation Technique

The DCF valuation approach, the most frequently used valuation technique, provides a "going concern" value calculated by the summation of the present value of projected cash flows for a determined period plus the present value of the residual value at the end of the projection period.

Typically, a 5 to 10 year projection period of preinterest operating cash flows, with various terminal or residual value estimates will be discounted back to the present by the risk adjusted, weighted-average cost of capital. The cash flows are derived from projected income statements and working and fixed capital plans. This calculation produces a result that represents the value to both debt and equity holders. The outstanding debt at the time of the acquisition must be subtracted from the total capital value to arrive at the equity value.

B. Value Versus Purchase Price.

1. Market synergies. A significant portion of the premiums paid over the stand-alone value of the target company are strategically motivated. Companies looking for valuable trade names, special technologies or valuable distribution channels are able to justify paying a premium because of the expectation of creating additional cash flows through the combination of their operations with that of the target's, for example, product cross-selling between client bases. Foreign investors in particular are known for paying high premiums for market niches or established brand names.
2. Cost reductions. Another element of incremental value is the expectation of cost reductions. Typically, corporate buyers expect to add value by

actions such as utilizing excess manufacturing capabilities and eliminating duplicate sales forces, distribution channels, and corporate overheads. These cost reduction expectations have become so prevalent that a due-diligence analysis may include the names, salaries, and re-assigned responsibilities and an estimate of the attendant cost savings.

3. Financial synergies. The analysis should also include any financial synergies and tax benefits that could be attained through an acquisition. An acquisition by a larger corporate or foreign buyer may decrease the inherent risk of the combined entities thereby decreasing the target company's cost of borrowing. Other expected synergies may be the utilization of net operating losses and the step-up in tax basis of assets.

C. The "Players" Perspectives.

Current U.S. mergers and acquisitions activity is broadly driven by three players: domestic corporate buyers, "financial" buyers and foreign investors, each with their own objectives and perspectives.

In order to understand the maximum purchase price that different buyers might be willing to pay to obtain the company (which may represent a premium over the stand-alone appraised value), it is necessary for a seller to understand the different perspectives of the buyers.

1. Domestic Corporate Buyers. These buyers generally acquire a target company because of either expected strategy benefits or synergies made possible through elimination of operating redundancies.

Many domestic corporate acquirers will also consider financial synergies such as tax benefits (e.g., NOLs and asset "step-up") and may consider the valuation implications of the tax deductibility associated with a highly leveraged acquisition financing structure.

Corporate acquirers will generally pay a higher price for any given company than a public stock offering would attract. The reason is a strategic buyer is willing to pay a premium price to gain control of an entire company.

2. Foreign Acquirers. These buyers, typically, are looking for strategic "footholds" in the U.S., although more active acquirers may be in a position to consolidate acquisitions with existing operations. Foreign acquirers may bring different required rate of return criteria to the bargaining table, which can be an important pricing factor. However, this differential has been narrowing, particularly for Japanese and West German acquirers. Also, some foreign investors place more reliance on asset replacement cost or liquidation value where manufacturing companies are involved than do U.S. investors.
3. Financial Buyers. A leveraged buyout (LBO) is the acquisition of an existing business orchestrated by a LBO sponsor or investor group and financed primarily with debt and equity capital. The new company uses the operating cash flows and the sale of nonoperating assets to service and repay the debt which it has incurred in financing the acquisition. Additionally, LBO investors can be very aggressive with respect to cost elimination.

A LBO typically focuses on cash because it excludes several accounting charges, such as depreciation, that can obscure a company's true earnings. For a mature company, for instance, hefty depreciation may trim reported net income, while the real value of its assets to a potential buyer may actually be appreciating.

D. LBO Analysis.

The new capital structure of the acquired company is designed to optimize the value of the firm's assets by minimizing the company's tax burden. A company's debt to equity ratio can be as high as 10 to 1 depending on such factors as the predictability and stability of its cash flow.

The primary valuation technique used by LBO investors is the DCF technique. The cash flows after interest, taxes and principal repayments are projected and discounted by the risk-adjusted cost of equity. The risk-adjusted cost of equity will often be considerably higher than before the acquisition because of the increased debt levels. This new risk-adjusted cost of equity will take into consideration two types of risk: operating risk - the risk associated with the company's operations, and the financing risk - the risk attributable to the company's capital structure. One indication of the increased risk is the lower-than-normal debt coverage ratios.

The maximum purchase price that the LBO investor is willing to pay is a function of anticipated cost reductions, the new capital structure, and the minimum equity returns that the equity participants are willing to accept. In most cases, the common equity investors expect a substantial annual compound return, generally 30% or higher a year. They expect to receive these superior returns as compensation for the financial risk being assumed.

A buy-out analysis often begins by checking the ratio between a company's total value (its debt plus the market value of its equity) and its pre-tax operating cash flow (or pre-tax operating profit plus depreciation). This multiple should be comfortably within a 6 to 8 times range based on recent sales.

Example. A company is valued at \$9.5 million. The buy-out will be accomplished with \$8.5 million of debt and \$1 million of equity.

The proposed restructuring includes the immediate sale of a \$3.5 million asset. This will reduce the value to \$6.0 million or 6.7 times the \$.9 million cash flow remaining after the asset sale.

The asset sale will reduce debt to \$5 million. Through growth and improved profit margins, management expects annual cash flow to grow to \$1.25 million in five years. After taxes and interest payments, they figure they will be able to retire another \$1.5 million of debt.

With improved cash flow and operating margins and reduced debt the restructured assets are projected to be worth 7.2 times cash flow -- or \$9 million. Subtract the remaining \$3.5 million of debt, and the value of the remaining equity would then be \$5.5 million. That means the \$1 million of original equity would grow 5.5 times in five years -- a 41% compounded annual rate.

The so-called financial or LBO investors over the last decade increased substantially in number and financial strength. For example from 1981 to 1989, LBO funds and their pension-fund investors took hundreds of companies private in a buy-out binge totaling more than \$250 billion.

However, the 1980s leveraged buy-out boom is now a memory, and LBO funds are rushing to cash out with sales of companies in their portfolios. One reason the companies are so ripe for sale, either to the public or corporate acquirers, is that LBO funds are anxious to sell to generate returns for their investors. That's unlike publicly traded corporations, where managements often resist takeover bids to avoid losing their jobs. Buy-out funds typically start thinking about taking a profit within a few years, once they have made any planned changes in a company and paid down buy-out debt sufficiently to generate a healthy return. Buy-outs typically generate the highest annual rates of return for their investor over a three-to-five-year period. The flurry of sales is occurring now because we're at a time three to five years from when a lot of buy-outs were done.

Future LBO activity will be slowed by the drop-off in the stock market as well as the collapse of the high-risk, high-yield junk bond market whose sale is typically used to finance 30% of a buy-out.

IV. Financing the Acquisition.

While the buyer and seller may be able to negotiate a mutually agreeable purchase price for the target company, few buyers have the desire or available assets to complete the transaction without securing debt and/or equity financing. The buyer will need to assess the costs associated with debt and equity financing and consider how the target or the buyer's consolidated operations will meet

its future obligations in terms of cash flow and return on equity. The buyer must also convince the lenders and investors that the buyer will be able to meet the obligations of the financing package.

The past few years have produced different kinds of debt and equity instruments which have made acquisition financing more flexible. This is due in part to the increased volume of transactions and, in part, to the buyer's goal of retaining as much equity in the new company as possible.

A. Forms of Financing

The principal forms of financing are debt --senior and subordinated -- and equity -- preferred and common stock. Increasingly, "mezzanine financing" is replacing subordinated debt and other forms of debt instruments. The term refers to those financial instruments that have characteristics of both debt and equity. Examples of debt and equity vehicles that the buyer may use include lines of credit, term loans, mortgage notes, convertible debentures, warrants, redeemable or convertible preferred stock and common stock.

This schedule depicts some of the key characteristics generally found in the four basic financing forms.

<u>Characteristics</u>	<u>Debt</u>		<u>Equity</u>	
	<u>Senior</u>	<u>Subordinated</u>	<u>Preferred</u>	<u>Common</u>
Tax deductible finance costs	X	X		
Covenants/ restrictions	X	X		
No required fixed payments			X	X
Can be used in tax-free exchange			X	X
Base for leverage			X	X
Common equity convertibility features		X	X	
Not subject to redemption				X
Cost of financing	Low	Higher	Higher	Highest
Dilution of ownership		X(a)	X	X
EPS dilution of shares		X(a)	X	X

(a) For example, subordinated debt may have attached warrants which may be common stock equivalents and ultimately lead to a dilution of ownership.

In addition to the basic debt and equity securities discussed above, a number of less traditional financial instruments have enjoyed popularity for both the buyers and investors:

- . High-yield, high-risk securities (so-called junk bonds) are general obligation bonds that have credit ratings below investment grade and are appealing to those investors willing to increase their risk, given correspondingly high rates of return.
- . Debt securities with interest and/or principal payable in cash or securities of the issuer at the issuer's option, so-called paid-in-kind or PIK securities.
- . Debt securities with equity warrants, giving the debt holder a participation in the future performance of the company.
- . PIK preferred stock which, like PIK debt, pays dividends in cash and/or additional shares of preferred stock at the issuer's option.
- . Adjustable rate preferred stock with interest rates that are reset at periodic auctions.
- . Debt securities with an investor put option.
- . Sale-leaseback financing which is similar to senior debt. These transactions are complicated by who receives the risk/benefit of the residual value.

The advantages and disadvantages of the financing form selected must be evaluated very carefully to ensure that it is the best alternative. While senior debt is the cheapest form of financing and offers the advantage of interest-expense deductibility, debt principal repayment is an additional drain on cash flow.

Interest expense is also a burden on the company's future profitability, and excessive debt levels may result in financial distress leading to the forced disposal of valuable assets, and, in some cases, to bankruptcy.

B. Leveraged Financing.

Historically, most companies have employed "traditional" capital structures comprising both short- and long-term senior debt tailored to the useful life of the company's assets, subordinated

long-term debt to help finance long-term assets, and permanent equity capital as a significant component of total capital.

Increased use of highly leveraged purchases over the last several years has resulted in significant changes in the collateral requirements and the number of lenders involved in financing acquisitions. This schedule shows how a buyer may expect a leveraged financial structure to compare with the more traditional structure:

Forms	Traditional Company				Leveraged Company						
	A	B	C	Mgmt Owners	A	B	C	D	E	Mgmt Owners	
. Debt											
.. Senior	X				X	X					
.. Subordinated		X				X	X	X			
. Equity											
.. Preferred							X	X			
.. Common			X	X				X	X	X	

Notice that in the traditional structure, the senior and subordinated lenders do not have any equity position. Rather, they look to the asset values to secure their loan(s), and to earnings and cash flow to support the expected rate of return embodied in the interest rate.

In the leveraged structure, some lenders also look to the asset values to secure their loans, and the interest rate to obtain an acceptable rate of return. However, because of the increased risk inherent in a leveraged transaction, subordinated lenders (such as investors/lenders C and D) often require an equity "kicker" as part of their compensation for providing the acquisition capital.

C. Cost of Financing.

The costs associated with both debt and equity financing are primarily a function of risk. Lenders and investors require compensation in proportion to the risks they bear in providing financing. Additionally, the liquidity of

the financing instrument (i.e., the relative ease of converting the instrument or assets underlying the instrument into cash) will also affect its cost. All else being equal, higher liquidity entails a lower cost of financing.

The cost of debt and the cost of equity differ primarily in two ways. First, the annual cost of debt is known (whether the interest rate is fixed or adjustable, it is explicit), whereas the cost of equity is never explicit and, thus, must be estimated. Second, since providing equity capital is riskier than providing debt, capital equity has a higher cost than debt. Although equity does not require fixed payments, its cost is inherent in the return on investment provided through dividends and stock price appreciation necessary to entice investors to provide initial equity capital, and to be willing to leave that capital in the business.

Senior debt is the least risky and the least expensive form of financing since its claims take priority to all other debt financing. Secured senior debt holds liens against specific assets such as inventory, receivables, and fixed assets and, therefore, is less costly than unsecured debt. Interest rates for secured and unsecured debt are generally based on a "spread" above the "prime rate" charged by commercial banks.

Subordinated debt is below senior debt in liquidation priority. Because of its higher risk as well as the difficulty in assessing the risk, providers of subordinated debt demand higher yields than those charged on senior debt. The interest rate required for many subordinated loans is so high that a portion of the required yield may be satisfied with an equity "kicker," usually warrants. Generally, equity kickers will have puts (ability to sell the instrument back to the issuer) at a minimum price in order to guarantee the lender a minimum yield.

Preferred and common equities are subordinate to all debt financings. Their economic costs are higher than that of debt financing because the investor will require a higher return on the investment to compensate for the higher inherent risk caused by a lower claim on the assets of the company. This investment return is comprised of two components -- dividends and appreciated value.

The cost of preferred equity is generally lower than that of common equity, although its dividend rate is generally higher and is accrued at fixed periods and is paid before common dividends.

Common equity, the riskiest form of capital, is more expensive than preferred equity because investors require a combined return from dividends and investment appreciation to reflect the risks assumed (lack of any claim on assets and lack of a specified periodic return, such as preferred dividends or interest). If the company does not meet the investor's expectations, it may not be able to raise new capital through the issuance of common stock.

D. Sources of Financing.

1. **Venture Capital Firms.** Venture capital firms are in the business of making high-risk investments, which usually includes their participation in the ownership of the company. The investment goals of venture firms are generally geared toward medium-range capital gains. They are willing to take financial risks, which make them a source of financing for leveraged buyouts. However, they are rarely interested in turnaround situations because it takes too long for their investment to become liquid. They may also require voting control before they will finance a deal, which drastically affects the buyer's ownership goals.

Venture firms will invest in subordinated debt, but generally only if it is convertible to equity, since they prefer to invest in any and all types of equity securities. They typically charge a one to two percent commitment fee and require a very high compound annual rate of return (35-50% compound) with a provision that will allow them to liquidate their position in five to seven years. This provision may be a "put" requiring the company to buy them out, or an agreement to register the stock which causes the conversion of debt to marketable equity securities (in which the company would retain a right of first refusal).

2. **Sellers.** The sellers of a target company may also be willing to provide financing. Seller financing is useful because it allows the buyer to reduce cash

investment in situations where traditional lenders would not be willing to provide additional financing. A seller may be willing to finance part of the transaction if the seller receives a premium over an all cash price or if the seller is convinced that the deal will not be completed without the seller's participation, and if the seller believes in the buyer's ability to operate the company and repay the loan.

Sellers who are willing to finance part of the transaction will usually take back long-term, subordinated debt such as purchase money notes and, occasionally, preferred stock. The terms of these notes will generally comprise longer maturities, deferred principal payments, balloon payments, and lower interest rates than outside financing. When the transaction involves a covenant-not-to-compete, employment or consulting contracts, or leases of property, the agreement should be structured to ensure maximum use of potential tax benefits.

Transactions that include the continued involvement of the seller, especially situations that may allow the seller to reacquire control, may not qualify for purchase accounting treatment.

Earn-out arrangements (arrangements in which sellers receive additional future consideration usually based on future earnings) are also used to compensate a seller in situations where the value of a company is dependent upon the occurrence of more speculative future events. In an earn-out arrangement, the seller has the opportunity to enhance the effective return he realizes on the sale by helping the company to achieve certain profit performance objectives.

E. Negotiating the Financing

A primary focus of negotiations is the restrictions and covenants lenders attempt to include in their loan agreements to protect their interests against a technical default and deterioration of the company's financial or operating condition. Many of the provisions reflect good business practices; however, excessive restrictions should be avoided. Typical loan restrictions include:

- . Limits on company stock pledged as collateral.

- . Negative covenants restricting management prerogatives in critical areas. For example, limiting the ability to raise additional long-term debt or preventing a sale or merger of the business.
- . Limits on dividend payments, company stock (treasury stock) acquisitions, or owner/employee salaries.
- . Capital expenditure restrictions.
- . Prohibition of the sale of a "substantial" part of the company's assets.
- . Restrictions on net worth, working capital and other financial ratios.

V. Postacquisition Integration

Why do so many acquisitions fail to meet the buyer's expectations? Commonly, business combinations are arranged by a small group of senior executives of the acquiring company without the involvement of operating personnel. The integration of the acquired company into its new parent is rarely well planned in advance because of the tendency to deal with more immediate priorities. Operational aspects tend to be addressed only after the legal combination has been achieved. This frequently causes serious disruptions, high management turnover and failure to achieve business objectives. A well-planned and executed integration process is critical to all acquisitions.

VI. The Business Plan

The business plan should provide both the debt and equity investor with a comprehensive view of the target that could aid the lender/investor in reaching a decision on whether or not to pursue the transaction.

A business plan demonstrates the viability and potential of the business, as well as management's knowledge and understanding of the variables that will affect the successful attainment of the company's objectives. It also provides the lender and equity investor a basis on which to evaluate both the business potential for return on investment and the individuals who will manage the company. Since the business plan is the initial presentation of the company's product and capabilities, it must be carefully prepared. It can also serve as a valuable planning exercise which should increase the chances of success for the company.

The business plan is generally a further refinement of the preacquisition review. A good business plan includes:

- . Executive summary
- . Historical background and description of business
- . Description of manufacturing process/sources of supply
- . Market and marketing strategy
- . Description of facilities and equipment
- . Management team qualifications
- . Financial summary, including projected and historical (audited where possible) financial statements, and any transaction-related pro forma adjustments

VII. Packaging Your Company for Sale

Owners are sometimes more concerned with tax savings than with reporting earnings and financial condition until they are seeking financing, going public or structuring their company for sale. Their accounting practices historically may be designed solely to minimize income taxes. Their financial statements may not have been audited or even prepared in accordance with generally accepted accounting principles. Such companies should be prepared to put their "accounting house" in order to package your company for sale.

Conformity of financial statements to prescribed rules and generally accepted accounting principles will be required by the acquiring company, particularly if it is public, because of SEC requirements. These requirements apply whether there is to be a pooling (exchange of shares) or an acquisition of your company for cash and/or stock. Poolings require that certified or financial statements be available for consolidation with the acquiring company on an historical basis. Under purchase accounting, the SEC requires that the historical financial statements of the acquired company are presented under certain conditions.

Even if statutory requirements are not a factor for the acquiring company, for the seller there is no way to demonstrate true financial condition or results of operations except by having financial statements prepared in accordance with generally accepted accounting principles.

Since most purchase acquisitions are highly leveraged (that is, accomplished by borrowing and pledging the assets to be acquired), it is necessary to demonstrate to the acquirer's financiers that the underlying acquisition has the assets and earning power required for leveraging.

The basic price for a company will be determined by a number of factors, all relating, of course, to its demonstrated earning power. Other vital considerations include whether the deal can be leveraged and the necessary tax benefits derived from the underlying acquisition, whether the purchase is of stock or of underlying assets. The acquired company's past tax practice may influence whether or not the deal can even be consummated and the price.

It is not necessary that the financial statements of the company be audited, but rather that they be auditable since the acquirer will generally review the underlying financial presentations using its own auditors and financial consultants.

Tax issues that may have to be addressed by some companies include treatment of cash sales, personal expenses, comingling of the owner's personal expenditures with company expenses and inventory "cushions" or understatements. The existence of such tax and accounting problems may impair a company's ability to demonstrate earning power and may require significant documentation in order to establish pro forma results of operations to the satisfaction of the buyer.

Related party transactions also need to be reviewed and perhaps restructured, particularly when a company is going public or when part of a group of related companies is being sold as an economic unit. If certain related companies are being sold, they must firm up their financial position by creating a discrete unit not dependent on other affiliated economic units. For example, if real estate is owned by the seller personally, he or she must decide whether to include that in the sale or arrange for long-term leases so that the economic viability of the unit being sold can be determined.