M&A in Succession Planning

AFPPR Annual Convention

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Why is Succession Planning Important?

- Different business and personal events can lead a business owner or founder to exit the company totally or partially, sometimes unexpectedly or on short notice

Personal Events	Business Events
• Retirement • Family transfers • Divorce • Death • Disability or illness • Relocation • New personal interests • Family needs	• Economic slowdown • Fundamental changes in industry • Loss of key employees • Quarrels among partners • Regulatory or legal changes • New business interests • Need to grow • Lack of strategic support / clout

The owner's motives determines the alternatives available

Owner's Motives and Alternatives

1
Stay on course and hold

Pros- No need to engage in transaction process, less friction

Cons- Lack of funding to pursue strategic endeavors or growth

2
Obtain Minority Investment

Pros - Obtain some capital to fund important initiatives

Cons - Funding may not be sufficient; limited investor base

3
Obtain Majority Investment

Pros - Obtain capital to deploy strategic plan, participate future growth

Cons - New owner and management to deal with

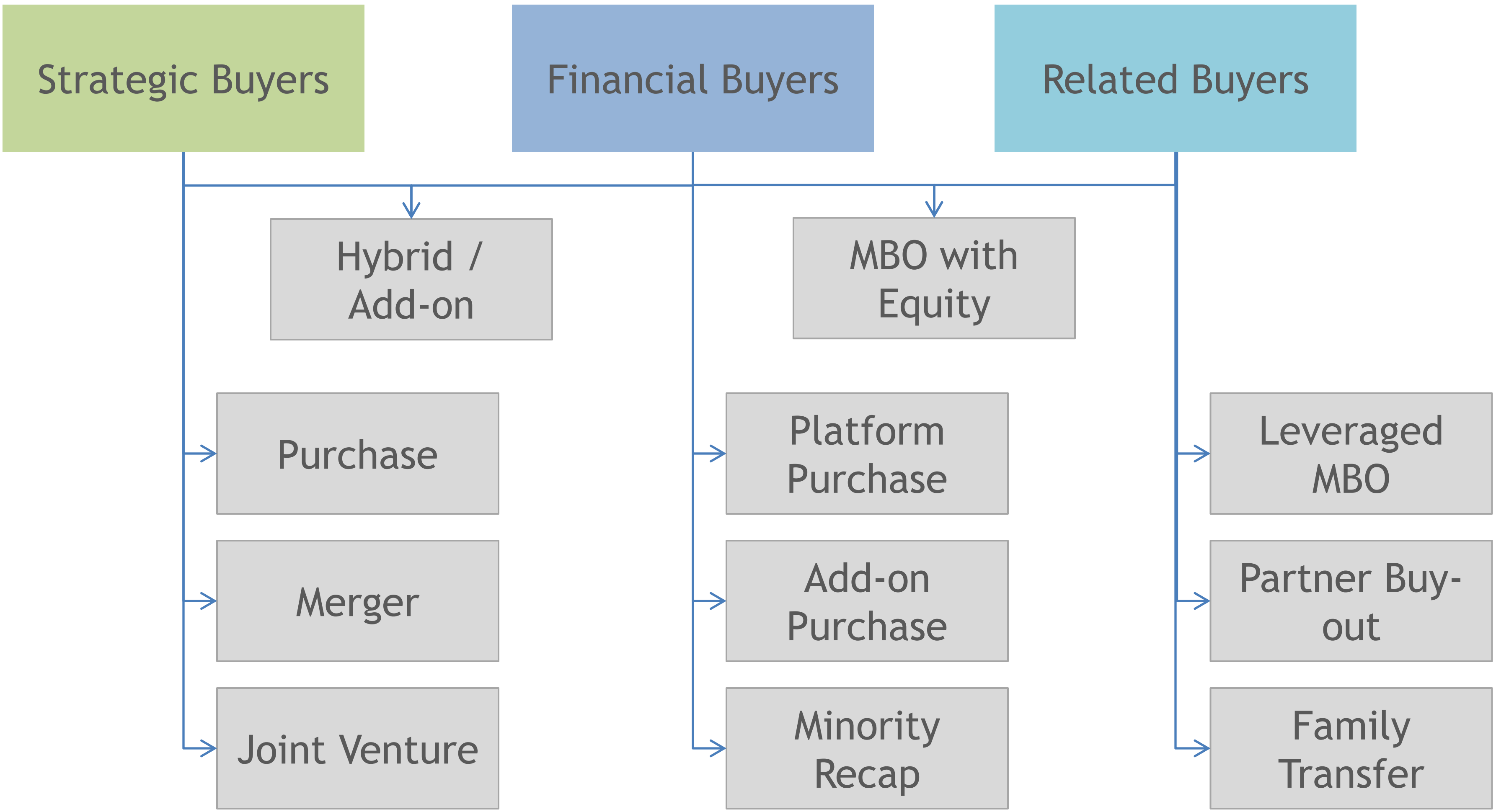
4
Full Exit

Pros - Obtain the most capital to address personal needs

Cons - No further participation, except for consulting

The alternatives available will be a function of the path chosen and the owner's motives

Transfer Channels



*Source: Robert Slee / AM&AA

Value Worlds

"The value of a business is relative to the purpose of the valuation , potential investor or purchaser, type of transaction and point in time in which the valuation is performed"

Owner Value	What the owner thinks his/her business is worth
Investor Value	What an investor thinks a business is worth (affected by their return expectations / cost of capital)
Market Value	The best value / bid received in a competitive process in a given point in time

The Concept of "Market Value"

- Ultimate value of a business is determined by the market (Market Value)
- The Market Value is the best price / terms combination obtained from a group of investors
- There are tools to estimate potential Market Values:

<u>Public Company Analysis / Trading Comps</u>:
-Publicly available information
-Similar operating / industry characteristics
-Apply relevant valuation multiples

<u>Precedent Transaction Analysis:</u>
-Recent comparable transactions
-Similar operating / industry characteristics
-Apply relevant valuation multiples

<u>Discounted Cash Flow Analysis</u>:
-Uses cash flow projections
-Exit multiple and cost of capital methodology
-Sensitivity analysis for key assumptions

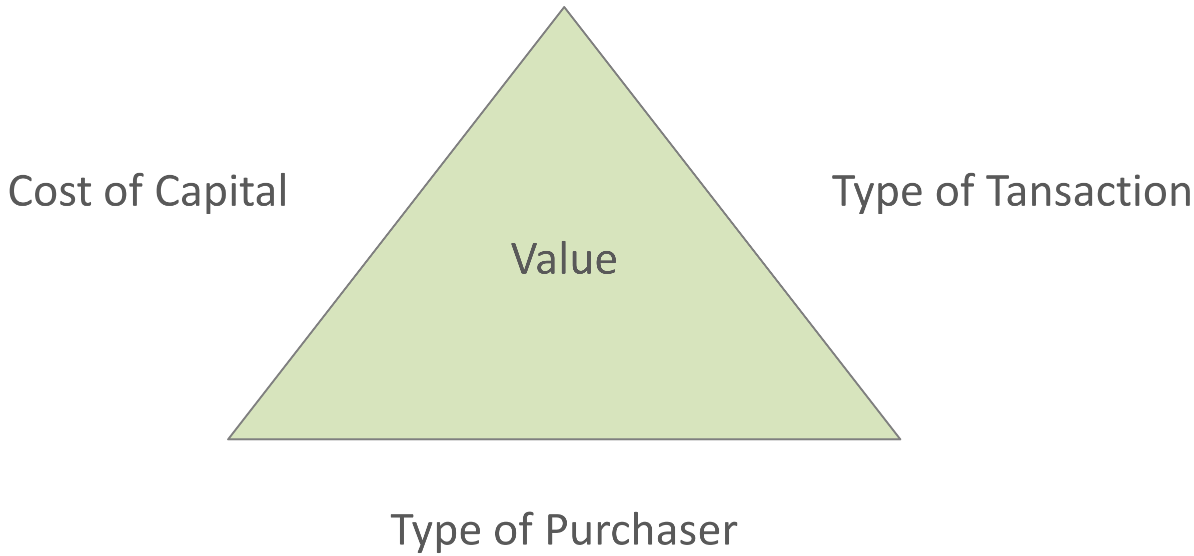
…Obtain Implied Valuation Ranges

Main Value Drivers:
1. Growth
2. Profitability
3. Size

Valuation Methodologies

- Trading Comparables of Publicly Traded Companies
  - Use as basis publicly traded companies that are similar in nature to the target company
  - Use selected metrics and multiples to facilitate comparison
  - Usually comprised of companies that could be potential strategic investors/buyers
  - Trading multiples are good indicators of the maximum price strategic buyers may be willing to pay (Trading Multiples v. Purchase Multiples)
  - Multiples of PR companies usually "trade" at a 25% to 30% discount to those of similar companies in the US
- Transaction Comparables
  - Evaluate past transactions as a proxy for future transactions
  - Use selected metrics and multiples to facilitate comparison
  - Provide a reflection of the values and conditions under which transactions were completed
  - Transaction multiples <u>tend</u> to reflect control premiums which result in higher multiples
- Discounted Cash Flow Analysis (DCF)
  - Involves taking future free cash flows and discount them to arrive at a present value, or intrinsic/internal value, of the firm
  - Accounts for time value of money
  - Uses free cash flows projected and a terminal value calculation to determine Enterprise Value

Putting the concepts together



- Cost of Capital – return expectations of purchaser or investor
- Type of Purchaser – strategic, financial, related
- Type of Transaction – merger, purchase, joint venture, management buy-out
- Value – a result of the possible combinations above and general market conditions /timing

The M&A process from a transactional perspective

1. Discuss seller's goals
2. Define transaction
3. Obtain preliminary data
4. Initial financial analysis / valuation
5. Discuss valuation and process
6. Engagement
7. Gather detailed information
8. Identify potential buyers/investors
9. Prepare offering documents
10. Market seller's business
11. Manage initial DD requests
12. Revise Letters of Intent
13. Select purchaser / no shop
14. Manage confirmatory DD
15. Transaction structuring
16. Negotiate definitive agreement
17. Closing process
18. Post-closing integration

The M&A process from a legal perspective

Stock Purchase

1. Offer is made by buyer
2. Confidentiality Agreement is signed
3. Initial due diligence begins
4. Letter of Intent is signed with non-binding terms and exclusivity
5. Full due diligence is conducted
6. Purchase and Sale Agreement is signed
7. Pre-closing conditions are met
8. Closing
    a. Resignation of corporation's directors and election of new board
    b. Releases are obtained
    c. Purchase price is paid
10. Stock Certificates are cancelled and new ones are issued
11. Shareholder's register is updated

Asset Purchase

1. Offer is made by buyer
2. Confidentiality Agreement is signed
3. Initial due diligence begins
4. Letter of Intent is signed with non-binding terms and exclusivity
5. Full due diligence is conducted
6. Seller's Board and Shareholders approve the sale of the assets
7. Asset Purchase and Sale Agreement is signed
8. Pre-closing conditions are met
9. Closing
    a. Title to assets is transferred
    b. Purchase price is paid

Letter of Intent

- Sets forth the principal terms and conditions to which the parties agree in principle in connection with a proposed transaction.

- Used to secure exclusivity and to test the waters before the long form agreements are negotiated.

- Two types of provisions:
  – Non-Binding: Deal specific terms such as transaction structure, purchase price, holdbacks, earnouts, escrows, caps, baskets, sunsets, and indemnities.
  – Binding: Regulate the process, the access of the buyer to conduct due-diligence, no-shop, non-soliciation, confidentiality, brokers, fees, and expenses.

No Shop (Exclusivity)

- No Shop: Provides that the negotiations will be exclusive during a pre-determined period of time.

- The exclusivity period is usually included in the Letter of Intent.

- Allows the purchaser to invest time and money in a full due-diligence without having to worry about competing offers, white knights, and auction scenarios.

Due Diligence

- The process pursuant to which the buyer discovers the state of the business that is being purchased.
- Possible obstacles or risks are identified.
- Mostly takes place after the signing of the Letter of Intent and before or after the signing of the Purchase and Sale Agreement (PSA).
- Usually encompasses:

  - Organization and constitutive documents
  - Shareholders, including agreements among them
  - Compliance with corporate formalities
  - Assets
  - Contracts, including leases
  - Licenses and permits
  - Capitalizations and finances
  - Debt and other liabilities
  - Labor matters
  - Environmental matters
  - Litigation
  - Intellectual property
  - Insurance

Confidential – For discussion purposes only

Transaction Structure

- What to keep in mind when determining optimal transaction structure:
  - Does the buyer wish to merge seller's operations?
  - Does the buyer intend to assume no liabilities or just certain liabilities or does the seller wish to retain certain assets?
  - What consents are required from a corporate perspective?
  - Are government approvals required?
  - Are third party consents required in order to transfer certain contracts and permits (e.g. Landlords/Bank)?
  - What is the tax impact of the transaction for buyer and seller?
  - Analyze the transaction's costs and who pays for them.

Transaction Structure (cont'd)

Stock Acquisition

- Buyer inherits all liabilities and contingencies of target
- Shareholders cannot be forced to be bought out, unless there is a drag along
- Seller Board approval is not necessary
- More streamlined closing documents
- Must identify control clauses provisions
- More tax efficient for seller

Merger

- Buyer inherits all liabilities and contingencies of target
- Buyer and target's operations and assets are merged into one
- Tax free if the consideration is exclusively in the form of stock from the target
- Requires a filing at the Department of State

Asset Acquisition

- Buyer can decide which assets and liabilities to acquire or assume
- Usually buyer does not assume non-disclosed contingencies
- Due diligence is faster and easier
- Assets in the buyers hands receive an increase in cost basis
- Could subject seller to double taxation

Additional considerations in connection with an asset deal

- Identify which assets and liabilities are not being sold or assigned.
- Asses whether successor employer doctrine applies.
- If a third party consent has not been obtained, can opt to:
  - Not close until the seller obtains the consent;
  - Close and the seller retains the Restricted Material Contract and transfer its “benefits” to Buyer; and/or
  - Desist from the transaction.
- Change the Seller’s name on or before the closing date to avoid unnecessary confusion.
- If there is a real estate involved, obtain insurance policy commitments before the closing date.
- Make sure to secure all necessary permits needed to operate assets.
- Remember to comply with the Bulk Sales Act.

Purchase Price

- The agreed upon price can be paid in:
  - Cash
  - Promissory Notes
  - Stock
  - Funds deposited in escrow
  - Earnout: An additional amount is paid depending on the company’s future performance:
    - performance goals
    - method of computing
    - who computes it
    - when and how it is paid
- Post-closing purchase price adjustments
  - Prior to closing seller has to compute the closing working capital or stockholders equity.
  - After closing buyer computes the closing working capital or stockholder’s equity.
  - An adjustment in favor of buyer requires a reimbursement or if there is a portion of the purchase price that was deferred or held back, it can be set off.
  - Adjustments in favor of seller would require an additional payment from buyer.
  - Pay close attention as to days to object.

Representations and Qualifiers

- Representations, warranties and covenants
  - Ownership or assets or stock
  - No undisclosed liabilities
  - Compliance with law
  - No liens
  - No litigation
  - No employment liabilities
  - Financial statements accuracy
  - No environmental liability
  - Tax compliance
- Most common qualifiers
  - Materiality
  - Knowledge
  - Material Adverse Effect (MAE)

Covenants

- Covenants: are obligations that must be complied with BEFORE the closing and regulate the sellers conduct between the contract signing and the closing
- Affirmative covenants are obligations to do something
- Negative covenants are prohibitions
- Examples of Covenants:
  - The Seller shall give the buyer access to the business and provide all due diligence information
  - Will conduct business in the ordinary course of business
  - Will not make changes in management
  - Will maintain the business assets in good condition
  - Notify if any representation turned out to be false or if it is possible that it could turn out to false or if any covenant was violated
  - Pay the corporation any debt of a related parties or an affiliated parties
  - Negotiate exclusively with Buyer
- Not fulfilling the obligations set forth by the covenants could result in the termination of the SPA.

Conditions to Closing

- The Closing Conditions section sets forth the conditions precedent to the obligations of each party prior to closing:
  - Certain deliverables
  - Accuracy of representations at closing
  - No MAC
  - No legal proceeding challenging the transaction
  - No breach of covenants
  - Obtain third party consents
  - Obtaining permits
  - Regulatory approvals
  - The expiration of the HSR waiting period (if applicable)

Indemnification

- Any breach of a representation made by the seller in the contract, the Disclosure Letter, the supplements of the Disclosure, or any other certificate or document from the seller can trigger indemnity rights in favor of buyer
- The knowledge that the buyer might have or the results of an investigation that the buyer might conduct, should not affect the right to be indemnified
- Make sure the indemnity includes the obligation to defend

- **Caps:** maximum amount of seller's liability to buyer under an indemnity
- **Basket / Deductible:** threshold below which a seller will not have liability to the buyer
- **Sunset:** term established by the parties for the duration of the indemnity obligations

Issues and relevant items in family transfers

- Is there a family member interested in handling the business going forward?
  - Is said family member involved in the business and has the required experience and skill set needed to run the business?
  - Does said family member have the funds (or access to financing needed to complete the acquisition?
- Is the founder willing to sell to said family member? Is he willing to donate all or a portion of ownership interest?
- Are the other family members (children) ok with the fact that just one or a few of them will own the business?
  - Are they willing to stay as a minority or non-controlling owners after the generation transfer?
  - Is the interested family member willing to have the others as passive owners?
  - If not, are there enough assets to satisfy the equivalent value for non-participating owners?