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GE Capital

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The Fundamentals of Successful Exits and Acquisitions

Also in this issue

- What Evolving Financial Reform Means for U.S. Businesses
- Done Deals
- Capital Comic
- Indices Watch
- CapitaLens Archive

Merger and acquisition transactions can be a viable alternative for accomplishing a number of strategic objectives in the context of building and realizing value for emerging growth and middle-market companies (those from start-up to several hundred million dollars in revenue).

Let's take a high-level view of the buy-side and sell-side processes, and a framework for thinking about and planning each.

Exits. In many instances the distinction between selling a company (i.e. an 'exit') and raising capital is measured by the amount of equity sold and the contractual rights obtained by the buyer. Financing growth raises the issue of long-term shareholder objectives, which often involve eventual liquidity. As the wave of business transitions driven by baby boomers planning their legacy and succession continues, some shareholders are confronted with a multifaceted decision of how to finance the continued growth of their business, create liquidity for their owners, and lay the foundation for operations independent of the owner/founder.

Others see the opportunity to buy-out partners or create some liquidity while staying in the game for what may be deemed a second bite at the apple. This is the concept of selling a controlling interest in a company to a financial buyer (i.e. a private equity group) and rolling over or keeping a minority interest until a subsequent sale or liquidity event happens when the company is expected to have grown in value, under the watch of the new owners with their capital. There are numerous examples where the sale of the minority interest in the follow-on transaction, three to five years from the first transaction, resulted in as much economic gain as the original sale to the financial buyer.

Shareholders and partners may find a full or partial exit attractive for many reasons, including:

- Diversifying away the risk of having too much personal net worth in a single asset
- Minimizing the risk of growth by obtaining a financial or strategic partner
- Buying-out passive partners and making room in the capital structure for management and employees without dilution to exiting active shareholders.

Several potential solutions exist, including recapitalization, sale to a financial buyer while keeping a minority stake, or an outright sale to a strategic or financial buyer with contractual rights for some level of future performance.

Recapitalization. Generally, a recapitalization will involve a lower cash-out (as a partial exit or staged exit) for the active owners than a buy-out (which involves a change of control). A recapitalization will most likely be focused on changing the relative mix of debt and equity with an eye toward the growth objectives of the company and the required go-forward capital. For example, a leveraged recapitalization will most likely increase the debt of the company in exchange for distributions, dividends or purchase of equity.

Acquisitions. Acquisitions can meet a number of goals if approached and executed as part of a long-term strategy. Some of the typical reasons executives pursue acquisitions include:

- Accelerate revenue growth
- Enter an adjacent market space
- Expand into a new geography or obtain a physical footprint in a new location
- Access new customers
- Access technology
- Strengthen the pool of talent and capabilities
- Complete or augment a product or service line
- Reduce costs
- Capture market share

- Prevent a competitor from gaining these advantages.

The first phase of a typical acquisition process addresses finding a target company to buy; this begins with the strategic plan that should lay the foundation to determine many of the parameters and the focus of the process. The second phase of the process is to structure the deal, close the transaction and integrate the business.

The financing strategy to support the acquisition should initially be thought of in the context of the overall acquisition process and be defined as part of the acquisition strategy (phase one), understanding that the process will evolve and is somewhat iterative as knowledge is gained from the marketplace. If your company is cash-flush or the acquisition target is immaterial in value, the financing strategy may be as simple as funding the transaction from operational cash flow or cash reserves. However, if the deal requires external funding, management must consider a financing strategy, which typically begins with understanding the acquiring or buying company. This involves:

- Determining its valuation and financial strength
- Establishing financial objectives and benchmarks for vetting possible acquisitions
- Determining parameters around how much the buyer can afford
- Conducting internal discussions around an ideal or preferred deal structure
- Establishing relationships with financing sources and obtaining buy-in regarding the acquirer's plans
- Obtaining evidence for potential sellers of the buyer's ability to finance and close a deal

From these parameters, management can then think about financing a specific target company, which is a function of the value of the target, likely cash flow of the target, the deal structure and the integration strategy.

Start by assessing the value of the target acquisition as a stand-alone business using traditional valuation approaches, then value the acquisition in the context of your business, giving consideration to cost savings and lift that may be obtained on a combined basis. Another metric that may be useful in the process is to determine the financeable value. This is the amount that can be paid using external financing based on the assets and cash flow of the target.

The deal structure and financing strategy are developed by weighing a number of factors to find the optimum solution to meet the objectives of the parties involved. Among other things, these factors include the integration strategy and the valuation gap - that is the value your company is willing to pay and what is required to get the deal done.

Management should keep in mind some core concepts as it takes an objective view and embarks on the acquisition process:

- Begin with the end in mind - set clear objectives and benchmarks to gauge attractiveness of potential target companies and particular deals.
- Develop the financing strategy up-front and establish relationships with likely sources of financing.
- Terms are likely to be more important than absolute valuation.
- Align the financing strategy with the operating/integration plan and deal structure.
- Focus on value creation.

Regardless of the eventual solution or desired outcome, start with the same process. The essence of the front-end steps in the selling or financing process is analysis and understanding of the shareholders' and company's objectives, financial and competitive position, growth strategy and initiatives, and valuation.

Keep in mind that whether selling the entire company or raising a tranche of growth capital, in the form of debt or equity, what you are really selling is the future cash flow of the business. While past performance provides credibility to management's claims, future cash flow is the foundation for valuation and usually the primary reason for buying or investing in a company.

Kenneth H Marks, author, ‘Handbook of Financing Growth’. This article originally appeared in *The-FinanceDirector.com* and is reprinted with permission.