

Buying A Company



**ATLANTIC MANAGEMENT COMPANY
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Atlantic Management Company is a leading valuation and financial advisory firm that has been serving New England's business, legal and financial communities since 1968. We provide our clients with a broad range of specialized services that meet their valuation, merger and acquisition, ownership transition, and corporate finance needs.

Our client list is widely diversified and includes many of New England's largest and most successful companies in both the private and public sectors. We work with companies in virtually every industry from basic manufacturing to emerging high-tech disciplines, as well as retail, wholesale, and consumer and business services.

Atlantic's reputation for excellence reflects the technical capabilities of our professional staff. Individually, each is a results oriented specialist with outstanding academic and career credentials. Together, they comprise a team with backgrounds in the fields of finance, economics, banking, accounting, taxation, engineering and management. We invest in people to further develop our firm and insure that our clients' needs are met in a timely manner. And we continually broaden our research capacity and computer modeling capabilities to provide our professional staff with state of the art analytical tools and data resources.

In every engagement we undertake, one quality prevails: Judgment. The result of over 30 years experience, the judgment we bring to each assignment uniquely qualifies us to develop workable solutions to complex business and financial issues.

Introduction

For many companies, acquisitions are part of their strategic plan to grow. While bank credit has been tight, there is a plethora of available equity and mezzanine funds for sound acquisitions. Deal flow tends to rise when valuations are high and deal flow decreases when valuations are low. The prudent buyers are often able to complete acquisitions during a period of depressed valuations, because they make a concerted effort to take advantage of this opportunity.

Successful acquisitions are difficult to execute and require very careful scrutiny. Acquisitions can be very distracting and time consuming, but when they work well, they can be enormously successful. A few years ago a \$10 million necktie company acquired a polo shirt company, just when casual wear was becoming popularized. This strategic move literally saved the company from extinction.

Motivation

In this fast paced rapidly changing world economy, standing still is not an option for success. Back in the '80s, Lee Iacocca popularized the phrase: "Lead, follow or get out of the way." Nowadays, you hear businessmen say: "Buy, sell or liquidate." There are some companies that are able to develop all their products or services internally and to expand geographically through organic growth, but that is unusual. Most companies need external (acquisitions) growth to supplement their core business.

The motivation, therefore, for buying a company is threefold:

- To grow by acquiring products/services which sell into mutually beneficial markets through cross marketing and to grow by incorporating new technology and techniques and to grow by re-energizing management.
- To build a larger critical mass, to diversify and to increase profits and shareholder value...all of which should improve the company's long term options including a possible IPO.
- To respond to the competitive pressures which includes acquisitions to prevent such valuable properties falling into competitors' hands.

Concerns

The buyer of a business should exhaust the alternative options to an acquisition such as joint ventures, licensing agreements, alliances, greenfielding and minority investments, etc. The buyer should also be concerned that they have the correct criteria by which to identify and evaluate potential markets and companies within those markets.

The buyer needs to "sell" his company to the selling prospect, so the buyer needs to gather as much information about the prospect and its market and illustrate how this merger can propel both companies to the next level.

Arguably, almost all acquisitions other than platform companies are strategic, so be careful that you don't overpay for add-ons by rationalizing that a high multiple is justified because the target company is strategic.

The buyer is usually concerned as to why the company is "really" being sold and whether he will be considered the "preferred choice." When courting the company for acquisition, cozy-up to the owners and/or CEO to understand the real issues and to create positive chemistry.

There is never enough data in analyzing the deal, (e.g. financials, product, market personnel, etc.). Often the acquirer must say, "enough is enough" and either do the deal or not do the deal.

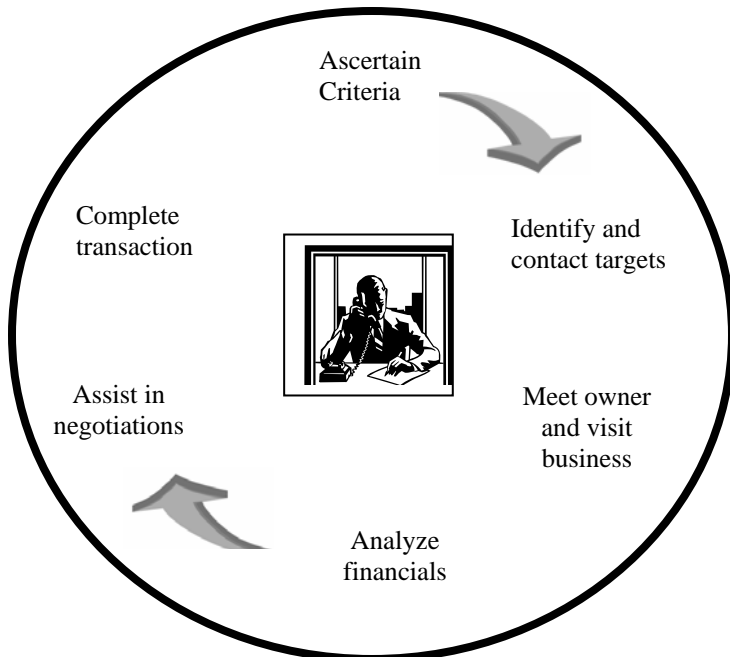
Valuation

There are different considerations in valuing a company depending whether the company is a manufacturer, a service operation or a distributor. Additionally, most corporate valuations are based on a combination of weighted methodologies such as industry comparables, capitalization of earnings, discounted cash flow, etc., and influenced by relevant value and risk drivers. The following are ten mistakes commonly made in corporate valuations:

1. Not verifying the quality of earnings. It is imperative that one understands the true earning power of the company. As a private company, it is not unusual for the owner to pay himself excess compensation. On the other hand, excess add-backs such as “one-time events” have to be scrutinized because all companies have some extraordinary expenses every year. Analytically, the appraiser of the business must separate the “wheat from the chaff” when it comes to establishing the true earnings of the company.
2. Not verifying the real value of the assets and liabilities of the balance sheet. The financial statements may be certified and accurate, but the real estate and machinery/equipment may be fully depreciated when in fact they are worth millions of dollars. On the other hand, there may be non-transferable leases on the real estate or onerous cancellation clauses for canceling undesirable leases on machines and equipment.
3. Not defining what earnings are being measured. Some people use EBIT, others use EBITDA. A multiple of 6 times EBIT can sometimes be equivalent to five times EBITDA. Or maybe it is better to use EBITDA – CapX. Furthermore, are the earnings a blend of the last three years, or last year, this year and next year’s projections. Or perhaps the earnings are the trailing 12 months regardless of the year-end. Are the earnings with or without add-backs and if so, what is the compensation for the in-coming replacement CEO?
4. Not explaining why a certain multiple of earnings or why a particular discount rate is being used. The solution of multiples and discount rates can be “objective” based on comparables of other companies, subject to certain revisions. Or their selection can be somewhat subjective, based on numerous factors such as company size, growth rate, industry, depth of management, proprietary business, etc.
5. Not defining what is really for sale. If one were selling a software company, what actually is the value. Does it include trademarks, patents, licenses, contracts, and have the employees signed confidentiality and non-compete agreements? The definition of value for a software company is more difficult to define than a steel mill, for example.
6. Not considering the value detractors. Most companies, if not all, have some aspects which detract from the business such as: customer concentration, outdated machinery/equipment, poor financial reporting, a messy plant, small market for product or service, price sensitive industry, technology threats, etc. Depending on the magnitude of these deficiencies, the valuation must reflect their impact.
7. Not considering the affect of the current market. The external factors described by some as macroeconomics have a definite influence. For example, now-a-days, middle market manufacturers sell for 4 to 6 times EBIT while a year ago the multiple would have been 5 to 7 times EBIT. For a company with a \$2 million EBIT, the difference would be a \$2 million valuation!
8. Not adhering to a process. Valuing a company is more than just reviewing the financials and coming up with a valuation number for the business; it is a threefold process. Initially, analyze the financials. Secondly, interview the CEO, review the list of clients, observe the accounts receivable aging, learn about the market, note the number of locations, learn about the important aspects, etc. Thirdly, review the assumptions and adjustments with the CEO and then compare them to the industry ratios.
9. Not considering the intangibles. Some companies have an exceptional history – perhaps a 100 years of doing business under a particular brand name. Other companies have recurring sales like magazine subscriptions compared to companies which might only sell a product or service once to a customer in his or her lifetime.
10. Not considering favorable relationships. Some companies like a liquor store may have the only available license in town or maybe the only allowable limestone quarry in a certain district. These favorable relationships would weigh heavily in the valuation.

Services Provided

In the engagement of Atlantic Management Company for buying a company, the following services are provided:



Finding The Deal

There are basically six different steps in buying a business:

- Assessing Your Strategy
- Finding the Right Company
- Pricing the Business
- Structuring the Transaction
- Financing the Purchase
- Closing the Deal

Most well-organized corporate buyers take three to six months to find an acquisition and three to four months to close the deal or ten months on the outside...assuming the buyer does not have serious problems like aborted letters of intent.

It is recommended that a buyer engage an investment bank to identify target companies through industry directories, online searches, trade associations, etc.; however, the investment bank should leave no rock unturned and therefore contact other investment banks, private equity groups, attorneys, accountants, etc, for companies that match the specific criteria. Furthermore, some bankers have skillful techniques in approaching target companies, which increase the chances of inter-facing with their CEO.

As a buyer, you do not want to overpay for a company; however, if you are not willing to pay “market rates” the chances of acquiring a good company are slim. If you turn down a company, it is very important to communicate your rationale with the investment bank or preferably receive their input before your decision is final. If you are to increase the chances of a successful acquisition, you should consider this project a corporate priority. On the one hand, you should be patient because an acquisition often takes up to a year or more to fully complete. On the other hand, you have to move with alacrity when an ideal company is willing to sell. The latter may require getting on an airplane the next day, rearranging the CEO’s schedule and delaying vacations.

About 50 percent of transactions fail to close at the letter of intent stage. By pursuing several companies at the same time, you not only “hedge your bet” but you create leverage.

Closing The Deal

Once you have found the ideal acquisition, you still have a long way to go before a successful closing...if in fact it closes.

You should be aware that not every company is sold to the highest bidder. Many sellers are concerned with the nature of the “fit” and the way they perceive they and their employees will be treated following the sale. Many deals fall apart after there has been agreement on the price between the two principals because of inflexibility regarding the structure of a deal. Structure often has pricing implications, so be prepared to offer alternative structures at different prices.

A very sensitive part for completing the transaction often comes down to the negotiation between the attorneys over the allocation of risk in the Purchase and Sale Agreement, (e.g. representations and warranties, indemnification, holdbacks and baskets, collars, etc.).

Pearls of Wisdom

1. A buyer should be talking with at least four or five potential sellers at any one time and actively negotiating with two or three.
2. Memoranda to oneself following each meeting, detailing the points discussed and minor or major matters agreed upon, are invaluable in keeping discussions on course.
3. You should avoid introducing a lawyer into discussions with principals before the elements of a business deal have been agreed upon. As soon as the buyer introduces such an expert into discussions, the seller does likewise. Since lawyers must protect the technical aspects of their clients' positions, more transactions have failed because of the premature introduction of such specialists than have been made.
4. Don't make a ridiculously low offer that will insult the owner.
5. Don't make complex deals.
6. Don't get hung up on assets; be a cash flow buyer. Lenders tend to look at fixed assets, while buyers concentrate on cash flow.
7. Keep the buying process moving as fast as possible. The buyer who is able to make rapid analyses and decisions will benefit from the momentum.
8. For any given deal, there is a limited window of opportunity. If you spend too much time raising equity after the target company is "in play," the window will close.
9. If you are having difficulty raising the necessary equity to complete the transaction, suggest that the seller keep the accounts receivables, the real estate, or even the machinery. Sellers can lease the equipment to the buyer.
10. If you plan to borrow money against machinery and equipment for your acquisition financing, your banker will need to have an official liquidation appraisal on the machinery and equipment. Anticipate this and have the appraisal done early instead of later so that the momentum of completing the deal is not lost.
11. Predetermine your acquisition borrowing power so that your financing will not come up short at the critical juncture of the transaction. For example, the following percentages are normal borrowing ranges:
 - Accounts receivable (90 days or less) 70-85%
 - Inventory (not work in process) 25-60%
 - Machinery & equipment 50-80% (of forced liquidation)
 - Land & buildings (of market price) 60-80%
12. The rule of one-third: After an equity investment of one-third of the purchase price, the cash flow must provide the CEO/owner's salary, a return investment, and enough money to service the debt.
13. Besides profitability, some successful buyers often concentrate on the following ingredients:
 - Strong and committed management
 - Steady and predictable business in noncyclical industry
 - Substantial market share
 - Admirable corporate culture
14. Agree at the outset that the party that is acquiring the business will draft all the documents and the selling party will then review and make comments. Not only does this sequence provide order for the transaction, but it is to your advantage as the buyer to draft the documents based on your understanding and your language.
15. When buying a company, target an industry, product, or service that is on the upswing. Conversely, few acquisitions succeed if the industry, product, or service is on the downswing.
16. The announced reason for the sale of companies is rarely the real reason. Investigate, take your time, and listen carefully. If you are getting bad vibes about the deal, get out of the transaction quickly.
17. In order for your attorney to be a deal maker instead of a deal breaker, don't expect him or her to win every point in contention.

18. Sellers are often selling their legacy, and so the dynamics of the sale are often more important than the top bid. The preferred buyer, in the eyes of the seller, is not necessarily the high bidder, but rather the one who has the best intentions, the best chemistry, and/or the best credentials. Buying businesses goes beyond the numbers. Unfortunately, many buyers drop the ball in romancing the seller.
19. A buyer's insensitivity to the owner of the selling company can destroy a deal. Be sensitive to the seller's attachment to the company and its employees, customers, and vendors.
20. Most deals take time to complete, usually from two to five months after the letter of intent. While you have to exercise some degree of patience, you must remember that 50 percent of all deals fail to close after reaching the letter of intent stage. It is very important to keep the momentum going, and it is imperative that you retain experienced counsel in closing deals. Most sellers, somewhere along the line, get cold feet, and so buyers must maintain the seller's interest.
21. Nonnegotiable items should be pointed out early in the negotiation, such as an asset versus a stock sale or that the buyer's note will be subordinated to the obligations to the bank.
22. For companies without audited statements, make sure you substantiate their financials with their tax returns.
23. The older the business, the better established it is and the stronger its customer and supplier relationships.
24. The more industries in which the company sells its product, the more protection it has from cyclically and/or an industry downturn.
25. The tax objectives of a buyer and seller are at opposite ends of the spectrum in an acquisition. The seller's goal in structuring a buyout is to maximize the after-tax cash in his or her pocket, while the buyer's goal is to maximize the seller's assets that can be depreciated or amortized.
26. The best growth companies, if a reasonable size (over \$10 million in sales), usually "go public" if management wants to cash out. On the other hand, poorly performing companies are more apt to be acquired.
27. Buying companies is usually cheaper than trying to grow them from scratch.
28. From a buyer's standpoint, a business is worth less if it is a Subchapter S corporation because of the lower book value resulting from the earnings flowing through to the owners. A lower book value is also going to reduce the leveragability of the transaction.
29. Try to get very close to the other principal because there is a strong possibility that his or her advisers are not experts in mergers and acquisitions. Additionally, the potential seller is apt to receive some opinionated advice from "country club" friends that invariably increases the seller's insecurity about the deal. Meeting along with the other principal even during the final negotiation will frequently improve the chance of not having the deal derailed by advisers.
30. If the buyer is not receiving information that was requested from the seller, it is an indication of a possible cover-up of facts. The buyer should consider other companies instead.
31. A critical issue in buying a business is access to capital.
32. Management: the most important issue you need to consider is whether the owner is the reason for the success of the business. If the owner leaves, can you fill this role?
33. Seller financing is a popular means of structuring the deal and is used in well over half of the transactions completed.
34. You should be sure that the CEO has the legal authority to sell the business. This may rest with the board of directors, a majority stockholder, a bank with a lien on the business, etc.
35. Knowing the strengths of a business is as important as, or perhaps more important than, understanding its weaknesses. Focus on the target company's competitive edge.

36. The art of the business acquisition process begins with techniques to find a large number of business deals and to find them before they come on the market.
37. Many people do themselves a disservice by looking at all deals that might be interesting. Targeting industries and types of businesses makes your search more efficient and more likely to succeed.
38. It is imperative that you follow up with anyone who gives you a referral. Report back to the person giving the referral, indicating what transpired. Not only is this professional courtesy, but it will lead to more referrals.
39. Make generous use of appraisers, (i.e., corporate, real estate, equipment, etc.). The appraisals will keep you from overpaying.
40. Price doesn't kill deals—terms do.
41. From a seller's perspective, if the deal falls through, a great deal of confidential information has been given to the wrong people.
42. Act with absolute clarity in all of your negotiations so that the potential deal breakers surface as early as possible and can be dealt with for as long a period of time as possible rather than at the eleventh hour.
43. In any negotiations concerning a promissory note, the interest rate and payment schedule are key issues. Interest rates often will track rates of commercial lenders. Parties also should evaluate various amortization options, including interest-only periods and balloon payments, as alternatives to equal installments of principal and interest over a given term.
44. In negotiating, if the seller wants a stock sale instead of an asset sale for tax reasons, then the buyer should request a lower selling price. If the seller wants a fully collateralized note from the buyer, the acquirer should negotiate a lower interest coupon.