



INSIGHT

Why You Should Be Prepared to Sell

Whether or not you plan to sell your business in the future, being prepared to sell now translates into greater value and success for your company.

by William Hanneman

Is your business ready for sale? Does it matter, if you have no intention of selling or if that event is years away?

Having advised business owners and managed the sale of many companies over the past 20 years, we can say without qualification that being well prepared to sell makes a significant difference in both the success and value of a business. Whether the plan is to ultimately sell the business or pass it on to the next generation, the attributes of a company that is prepared for a sale translate into greater value for the owners. Preparation positively affects the price received and reduces the time needed to consummate a transaction and the amount of risk retained by a seller after closing.

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The discipline associated with planning a sale forces owners (sellers) to adopt the perspective of a new investor (buyer) and invariably leads to an effort to clean up loose ends that were easily put off in the past. We have often found that interest in selling can shift rapidly based upon changes in personal circumstances or the development of a compelling opportunity that emerges when least expected. Much of the planning that can have a real impact on value must be done years in advance; therefore, we are convinced that it makes sense to always be prepared for that possibility. Doing so pays big dividends,

STRIVE FOR INDEPENDENCE

If there is a central theme to this issue of Insight, it is that business independence is a key element of corporate value. In our view, independence is best defined as a company's ability to achieve consistent economic success without undue reliance on a single critical person, customer or supplier. The bottom line is that a business that continues to succeed despite a change of ownership, or the departure of a key manager, customer or vendor, is inherently more stable and, therefore, possesses greater debt capacity and is more valuable.

Sometimes, this is a lesson that owners of closely held businesses struggle to accept. We have witnessed innumerable situations where business owners are so tightly engaged in company affairs that key relationships (customers, suppliers and capital providers) are never entrusted to others, so a strong and sustainable management team is never allowed to develop. Only when the entrepreneurial owner is willing and able to put in place a team of people and systems and, then, steps back and trusts that team and systems to effectively manage the business, can real business independence be achieved. That air of independence is, in our experience, a factor that sets the most highly valued businesses apart from the pack. ♦

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Being always ready to sell proved to be quite valuable for Bill Cotter and Greg Davenport, the owners of DaVinci Gourmet, which was recently sold to the Irish food conglomerate, The Kerry Group. Without solicitation, Bill Cotter received an inquiry

from Kerry about his interest in selling. Conversations led to the conclusion that Kerry's current strategic interest represented a unique value proposition. Although Bill and Greg had no current plans to sell the business, they had always operated the business so as to be prepared to do so. Their planning efforts were largely responsible for completing the sale within 30 days from the agreement on the price.

"Greg and I always knew that we were going to sell, we just weren't sure when. We

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routinely received inquiries from parties wanting to buy the business and I always wanted to be in a position to respond intelligently. That paid off handsomely when Kerry called."

REDUCE PERCEIVED RISKS

Value is enhanced to the extent that the future is predictable. Actions that foster stability and reduce risks that could negatively affect the business create value for owners, whether continuing or new. A couple of areas of risk that commonly plague deals include customer and supplier concentrations, and management depth and stability.

A diversified customer base is among the most valuable attributes of a business. Businesses that serve only a small number of customers generally suffer greatly at the loss of one. Reliance on a handful of customers directly impacts business value. The same issue arises when a company becomes overly reliant on a single supplier.

Just as a major customer's departure can diminish value, so can the loss of key

employees. Building management bench strength that can perpetuate the business creates value for the owners. To the extent that a buyer perceives that the business has the management depth to move forward successfully without the continuing involvement of the owner/seller, a major element of risk is alleviated. Management depth is a prudent long-term investment, not a short-term cost.

When it is all said and done, a buyer wants to acquire all the ingredients to future success. At the top of that list is a competent management team. Therefore, tying the managers' interests to the company is important. Employment contracts, stock/options, deferred bonus plans and other mechanisms should be used to cement management stability through a change of control. Likewise, all employees should execute confidentiality and non-compete provisions.

SEGREGATE REAL PROPERTY

If the business operates from real property that is commonly owned, an effort should be made to segregate it from the operating assets. Real property does not have the same value attributes of an operating business. This is particularly true for property that has alternative uses.

Real estate investment is distinctly different from business investment and, therefore, most buyers of businesses choose to rent real

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estate and own businesses. Owners (as well as buyers) often have difficulty properly allocating value between real property and an operating business. The appropriate value of each can only be established when the business pays rent to the property owner at a market rate. The strategy of subsidizing the company with below market rents until a transaction closes, and then increasing the rents to fair market value, rarely pays off. The buyer realizes the business is not as profitable as it seems and adjusts the value accordingly. Providing the buyer the flexibility to separate the ownership of the business from the ownership of the real property removes a challenging sale obstacle.

QUALITY NUMBERS

Buyers expect that sellers will stand behind the accuracy of the historical financial

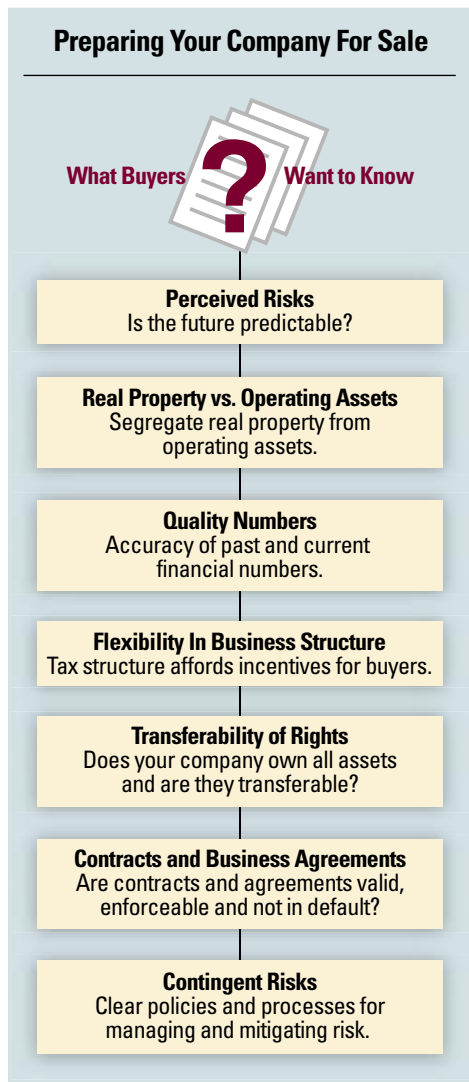
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performance and current financial position. Independent assessments of accuracy reduce the potential for future adjustments for both the buyer and seller. A full-scale audit may not always be necessary. However, if inventory is a significant asset, it is advisable for outside accountants to periodically observe physical counts and valuations. Independent verification of inventory balances will allow confirmation of gross margins and historical performance.

Aggressive expense policies are the norm in closely held businesses. It is also beneficial to maintain a detailed tally of all one-time or non-business related costs (particularly those



that relate to ownership) when it comes time to sell.

FLEXIBILITY IN BUSINESS STRUCTURE

Tax laws offer an incentive for buyers to structure the acquisition of operating businesses as a purchase of assets rather than stock. If a premium over the book value of net assets is to be paid, a buyer can potentially allocate that premium to the value of the assets. This allocation, up to fair market value, can be depreciated over the useful life of the assets to create an additional tax shield, essentially lowering the effective purchase price. A buyer of stock is not accorded the same benefit and, therefore, may be willing to pay less for the same business. In order to provide a buyer with the benefits of an asset purchase without adverse tax consequences to the seller, the business must

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be operated as a pass through entity (e.g. S-Corp, LLC, or partnership) for tax purposes. A sale of assets in a non-pass through entity is the worst of all worlds, being taxed both at the corporate level and at the personal level when proceeds are distributed to the owners. Remember it is not the price paid, but what is kept after taxes that matters.

TRANSFERABILITY OF RIGHTS

Again, a buyer wants to acquire all of the rights and assets necessary to operate the business successfully, including contracts, leasehold interests and intellectual property (e.g. trademarks, patents, and licenses). There are two essential issues: does the company actually own these assets and are they transferable? It is often time consuming and expensive to nail these issues down at the time of a sale.

ORGANIZATION COUNTS

It is not unusual to conduct business with important customers or key suppliers on a handshake or long after a contract has technically expired. Nevertheless, buyers always insist on reviewing all contracts and business agreements and require that the seller warrant that all such agreements are valid, enforceable and not in default. Typically, this is not a problem when agreements are well documented, organized and up-to-date. The same is true for licenses and permits. Accordingly, being prepared to sell means having ready access to all commitments and

Mezzanine Financing

An intermediate stage of capital, mezzanine is typically employed by middle-market companies to fill a shortfall in financing.

by Michael Newsome

Mezzanine is a tier of higher risk capital almost exclusively geared toward privately held companies with specific event driven financing requirements. This capital combines the characteristics of debt and equity and is often referred to as subordinated debt. Like the architectural term from which it is derived, mezzanine financing represents an intermediate stage of capital, squeezed between senior secured loans and equity financing.

Mezzanine is the private equivalent of public high yield debt. Issuances usually range in size from \$3 million to \$25 million, but can be as large as \$150 million. In most cases, public high yield debt is a more attractive alternative for financings in excess of \$100 million.

APPLICABLE SITUATIONS

Mezzanine capital is typically employed by middle-market companies (revenue of \$20MM to \$500MM) to fill a shortfall in financing imposed by limitations on secured borrowings because of either insufficient collateral or excessive financial leverage (the ratio of debt to cash flow). These two variables, which are key determinants of senior debt capacity, tend to move up and down depending on the appetite of bankers for new business.

Mezzanine is commonly an event driven transitional financing source, providing funding for high rate of return investment opportunities for mature, developed companies. It makes sense in circumstances where the investment will earn a return that creates incremental value for the equity holders. In other words, if an investment is realistically anticipated to provide a 12% return on capital, it makes little sense to fund it with subordinated debt that requires an 18% return. Companies tend to use mezzanine as bridge financing for events of this type. Once the anticipated cash flow benefits begin to be realized from an acquisition or a major capital investment and senior debt capacity expands, the relatively high cost of mezzanine capital provides a strong economic incentive to replace it.

The two primary situations where mezzanine is typically employed are:

- Funding a capital investment as part of a major plant expansion or an acquisition that is intended to provide significant growth; or
- Reengineering the capital structure in order to buyout one or more shareholders or pay out a special dividend.

In the former case, the new investment is

expected to be the catalyst for a significant increase in corporate value. The latter situation is designed to maximize equity returns through the application of financial leverage.

The most suitable mezzanine candidates are mature businesses with stable or growing margins, defensible market positions,

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well-defined strategies, and competent management teams. It is not a high risk capital source that will step up when the bank balks because of performance problems. Likewise, it is not suitable for early stage, emerging technology, or turnaround situations.

TYPICAL TERMS

Mezzanine investments are typically structured as a term note, coupled with an “equity kicker” in the form of either warrants for the purchase of a minority share of common stock at a nominal cost, or a deferred fee. Investors / lenders earn their return from the combination of:

- An upfront commitment fee,
- Interest paid on a current basis,
- Accrued interest added to the loan and paid on a deferred basis (known as payment-in-kind or PIK interest), and
- Value realized from warrants as the company’s equity value increases.

Mezzanine providers customarily target annual, all-in rates of return in the 15% to 22% range over the life of an investment. Required returns vary based on the degree of financial leverage, the size of the company, the strength and stability of the cash flow and the competition among lenders to provide the capital. The table below provides a comparison of the conventional terms and cost of mezzanine relative to other tiers of capital.

The one area where mezzanine tends to be decidedly less flexible than senior debt is call protection. Mezzanine often carries steep prepayment fees designed to keep the capital in place for as long as possible. A typical call protection provision would require a prepayment fee of 5% of principal in the first year and ratchet down by 1% each succeeding year. The note can be repaid without any penalty by the end of the fifth-year. When the interest meter is running at 15% or more per annum, it often makes sense to repay the mezzanine in spite of the high prepayment costs.

	SENIOR SECURED	JUNIOR SECURED	HIGH YIELD	MEZZANINE	PRIVATE EQUITY
Rank	Senior	Structural Subordinate	Contractual Subordinate	Structural/ Contractual Subordinate	Junior to all debt
Security	1st liens	2nd liens	Unsecured	Unsecured/ secured	N/A
Term	5-7 years	5-7 years	10 years	5-8 years	N/A
Coupon	Cash Pay (floating)	Cash Pay (fixed)	Cash Pay (fixed)	Cash Pay & PIK (fixed)	Dividends
Pricing					
Upfront Fees	1-2%	1-2%	None	2-3%	Varies
Interest Rate	L+200-300bp	11-13%	11-14%	12-14%	N/A
PIK	N/A	N/A	N/A	4-6%	N/A
Warrants	N/A	N/A	N/A	Almost Always	N/A
All-in Pricing	L+350-500bp	12-14%	9-10%	15-22%	25%+
Covenants	Comprehensive	Comparable to Sr. Debt	Incurrence tests	Financial Maintenance Tests; cross default with senior lender	None
Prepayment	Generally permitted w/o premium	Generally permitted w/o premium	Expensive call premiums	Expensive call premiums in the first 2-3 years	N/A
Capital Providers	Banks and Asset Based Lenders	Specialized Asset Based Lending Firms	Institutional Investors via Public Offering	Banks, Insurance Companies, Mezz Funds and Private Equity Firms	Private Equity Firms

Prepared to Sell *continued from p.2*

obligations of the business in a single location and ensuring that they accurately reflect the terms and conditions under which the business is currently conducted.

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CONTINGENT RISKS

Risk is an unavoidable element of business. Prospective buyers always expect the worst. How the business manages risk, in terms of product warranties, lawsuits, environmental concerns, pension plans, and regulatory compliance, says a lot about the quality of its management and the potential for future problems. For that reason, it is important to have in place clear policies and processes for managing and mitigating risk. Where possible, such issues should be dealt with head on rather than being allowed to drag on. In all cases, they should be thoroughly documented. Don't leave these matters to the imagination of the buyer.

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This, of course, is not meant to be a definitive checklist of all issues and concerns that must be dealt with in the process of preparing for and closing a business sale. However, these issues almost always have a material impact on value and are generally difficult to change in the short run. It is never too early to systematically lay the foundation for a sale even if you believe it is far beyond the horizon. It has been our experience that attention to these tasks results both in a better-run business as well as one that is poised to attain the highest value in a sale. A good way to get going is to call in your trusted legal and financial advisors and ask them to conduct an audit of your current practices and make recommendations. Do it now, it does make a difference. ♦

Mezzanine Financing *continued from p.3*

WHY MEZZANINE?

Owners of privately held businesses are attracted to mezzanine for several reasons.

Flexibility and patience – relative to senior debt, mezzanine is typically structured with a longer term and requires little or no amortization in the first three or four years of its tenor. It is common to see subordinated debt structured as a five-year bullet loan. The covenants usually contain less restrictive financial tests that focus on maintaining cash flow and limiting financial leverage.

Control – although more expensive than senior debt, mezzanine does not impose the shareholder dilution and loss of control that is part and parcel of private equity.

Leverage – mezzanine is an effective way to expand the total debt capacity of a business beyond the collateral and cash

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flow constraints imposed by senior lenders. It is fair to note that senior lenders tend to view companies supported by institutional lenders/investors more positively. These firms are often rewarded with more favorable credit terms.

The most significant benefit of mezzanine is that it reduces the amount of equity that is required to fund a transaction. Although mezzanine is expensive relative to senior debt, it is substantially cheaper than equity. For owners of closely held businesses, the idea of parting with some amount of ownership can be a major deterrent to the use of mezzanine. Nevertheless, mezzanine inves-

tors are not long-term shareholders bent on control. The warrants are simply used as a method to tie the lender's return to the incremental value of the business that their capital helped create. The lender's fundamental objective is to earn a return that is commensurate with the business and financial risk taken.

MEZZANINE PROVIDERS

Historically, the most active providers of mezzanine capital have been insurance companies and dedicated mezzanine limited partnerships funded by institutional investors such as pension funds and endowments. In recent years, the field of mezzanine providers has expanded to include leveraged public funds and the captive mezzanine lending arms of private equity firms, commercial banks and investment banks. The private mezzanine market was quite robust during the late 1990's - growing in concert with the overall M&A activity. As leveraged lending cooled and M&A activity sputtered during the past three years, the weak volume affected the demand for mezzanine. With senior lenders still showing conservatism, the market upturn is returning mezzanine to an important component of leveraged finance.

CONCLUSION

When a significant opportunity presents itself to increase the value of the business and the bank is unwilling to provide all of the necessary funding, mezzanine can provide the bridge capital to make that step without suffering significant shareholder dilution. We have been involved as advisors and placement agents in a number of situations where clients have used mezzanine to supplement senior debt in order to fund major strategic opportunities. The ability to fund the business strategy with mezzanine propelled these companies to a new level and generated attractive returns to the shareholders. ♦

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to ZacharyScott.com.

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