Zachary Scott
TRUSTED ADVISORS

*Zachary Scott—an investment banking and financial advisory firm—has published this newsletter since 1997 to bring you a thoughtful analysis of issues affecting middle-market businesses.*

PERSPECTIVES ON THE CAPITAL MARKETS SPRING 2018

IN$IGHT

# Where Private Business Acquisitions Go Wrong

## Part II: Thoughtful Post-Merger Integration

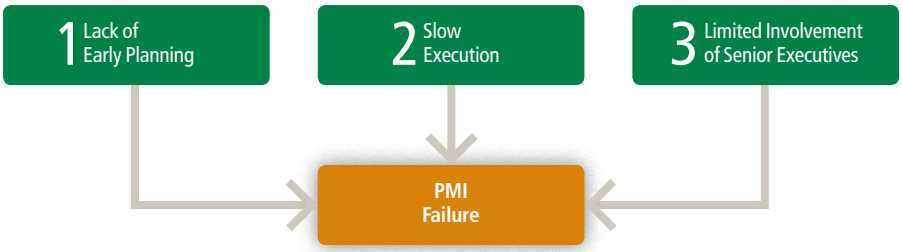
*by Kapil Sharma*

In the previous issue of IN$IGHT, we discussed why successful private business acquisitions need clear strategic rationale. In this article, we explain why post-merger integration ("PMI") is important and share some learnings from our work with successful acquirers.

Fundamental to all M&A deals is the continuation of the business trajectory and the promise of capturing synergies. While a continuation of the existing business is often taken for granted, the effort involved in the deal process can distract management from this central goal. Synergies can increase revenues, reduce costs, or accomplish both. Effective PMI is critical to assurance of a steady base and realizing these synergies.

While each PMI effort is unique, they are all challenging, time consuming, and demand extensive planning. Executives consistently underestimate the capabilities and resources required to successfully integrate acquired businesses. In our experience, most PMI failures can be traced to three key issues: lack of early planning, slow execution, and limited involvement of senior executives.

**Three Key Issues that Lead to PMI Failure**




### START PMI PLANNING EARLY

Many M&A teams emphasize risk and financial due diligence over development of post-closing action plans. In order for the target business to perform after the acquisition, people actually have to do things and, to achieve synergies, they have to do something different than what they did before. Even in the face of acute lack of information about the target and limited access to key employees, converting the beauty of the spreadsheet into concrete actions and responsibilities is essential.

To improve the chances of capturing synergies, we have seen successful acquirers expand the due diligence team to include individuals with a deep understanding of both the target's and the acquirer's customers, products, suppliers, distributors, or functional units. The choice of these individuals should reflect the deal's strategic rationale. For example, if an important objective of the transaction is cross-selling to existing customers, the due diligence team should include individuals with a deep sales and marketing background.

While it is important to start PMI planning with the right resources early, it is equally important to temper short-term enthusiasm. There is often a temptation to overstate synergies or to be excessively enthusiastic about how quickly they can be realized. However, PMI planning should be realistic and, ideally, the individuals tasked with functional due diligence should also be accountable for delivering PMI outcomes.

**Even in the face of acute lack of information about the target and limited access to key employees, converting the beauty of the spreadsheet into concrete actions and responsibilities is essential.**

A meaningful end product of the planning effort would be a well-defined "integration playbook" that catalogs key synergies and the critical tasks to be performed during integration, along with responsibilities, timelines, and inclusion into management incentive plans.

We witnessed the impact of well-developed integration plans in a recent M&A transaction in the trucking industry. Well before closing, the acquirer created clear plans for route and terminal consolidation, driver integration, and customer communication. As a result, the acquirer captured most of the expected synergies far ahead of schedule.

### ACCELERATE EXECUTION

Integration delay often erodes business value. Following the trauma of the transaction, it is not unusual to have buyer executives put a moratorium on change to stabilize the organization. It is also not unusual to hear the statement, "we are going to take the best from each organization and create an even better organization going forward." In either case, value capture of synergies is delayed and the opportunity to affect change is made more difficult as the entire organization is confused as to the direction and course.

There are two kinds of integration – business administration and business model alignment. The former deals with issues such as consistency of pay scales, reporting structures, benefit program conversions, policies and procedures communications, and systems. The latter deals with the ways in which the combined business reacts with its supplier and

*(continued p.2)*

customer base in order to maximize its position in the market. Examples might be consolidation of sales force and coverage realignment, eliminating redundant functions and people, or consolidating facilities and processes. After the transaction closes, many acquirers set up an integration team to manage the transition, with primary emphasis on integrating business administration functions, with the real value creating actions taking a backseat.

Some acquirers expect people to integrate themselves. This is wishful thinking. The truth is that businesses don't merge, at least effectively. Resolution of people and power issues should not be delayed. Successful combinations are almost always a takeover with one culture, mission, and strategy surviving. Converting the acquired into that overall strategy is the most important integration function that can be accomplished. Delaying achievement of that goal can confuse the employee base and its customers. Business performance suffers, and competitors are all too happy to take advantage of the situation.

Our experience executing transactions in the waste and recycling industry leaves us impressed by the industry's rapid pace of integration. Executives did not shy away from making tough decisions and integration teams ensured everyone stuck to the playbook timetable. In contrast, we have also been part of mergers in the seafood industry where acquirers took years to consolidate plants that literally sat next to each other, never achieving available operational and cost efficiencies.

**INVOLVE THE EXECUTIVE LEADERSHIP**

Executives need to be actively involved in managing the integration, setting the pace, making tough decisions, monitoring performance, and celebrating integration victories. Leaders should specify which integration issues are non-negotiable as early as possible.

**Successful leaders embrace "selling" the deal to employees. They need to proactively and meaningfully address what the deal will mean for the future of all employees, not just customers or shareholders.**

For example, it might be prudent to specify migration to a unified IT platform instead of debating whether the target should be allowed to keep its data systems. Closing facilities, laying off people in redundant functions, and reassigning accounts and sales coverage should be done with urgency. Change needs to occur as quickly as possible so that the future can become the important focus.

In our experience, successful leaders embrace "selling" the deal to employees. They need to proactively and meaningfully address what the deal will mean for the future of all employees, not just customers or shareholders. The leadership team should quickly commit to the culture they want the integrated entity to embrace, with personnel and compensation decisions rewarding individuals that embrace the new culture, not resist it.

**IS THIS ENOUGH?**

The PMI suggestions discussed above work best when the target operates in the same industry or faces the same competitive threats as the acquirer. These efforts also work in situations where the target is kept operationally separate from the acquirer's core business or where the objective of the acquisition is simply to acquire certain skills and technologies.

On the other hand, some M&A transactions are unrealistically ambitious. Simultaneously entering new markets, incorporating new channels, introducing new products, and/or fully merging operations complicate the already difficult PMI process. Obviously, such transactions have exponentially higher PMI risks and correspondingly high rates of execution failure. Leaders are advised to proceed at their own risk or go back to the drawing board to (re)define the strategic rationale.

**ON TO CULTURE**

As we have seen, capturing sustained economic value in any M&A transaction can be challenging. However, regardless of deal size or complexity, managing "the way we do things around here" – also known as culture – is a key determinant of long-term success. Our final article of this series will discuss how to analyze, define, and bridge cultural differences. **zs**

# ESOPs—A Different Angle

## Without tax incentives, ESOPs might not exist

*by Frank Buhler & Mark Working*

One of the many arguments in favor of using an employee stock ownership plan ("ESOP") to facilitate an ownership transition is that ESOPs create better companies. Because employees are owners, they have a vested interest in driving greater company performance. Increases in employee productivity and accountability, and therefore company profitability and value creation, will follow.

The fact is that ESOPs would likely never occur in the wild but for the tax benefits that accrue to the selling shareholder(s), the company, and the ESOP participants. There are many alternative mechanisms to bestow gifts upon and incentivize employees, including providing equity return characteristics. These mechanisms can be customized to the situation, but generally they do not receive all the beneficial tax treatment provided to ESOPs from the federal tax code.

Rather than buyers, ESOPs are tax-weighted corporate finance tools used to facilitate recapitalizations. We think they are proposed for many situations, but fit only a few.

**ESOPs DON'T BUY SHARES; THEY ARE GIVEN SHARES**

ESOPs have no capital and, therefore, no ability to "buy" anything. The structure under which an ESOP "buys" the stock of a company requires the company to "give" the funds to the ESOP to allow it to buy shares from the existing shareholders. The company obtains the funds by borrowing from a third party. The loan is secured by company assets and in some cases with seller proceeds from the sale. To illustrate the mechanics, the diagram on the following page shows the flow of cash to transfer ownership to an ESOP. At the end of the transaction, the owner has received cash for part of his ownership as a result of a loan to the company.

To put some numbers to it, we assume the company is valued at $30 million and a sale of 30% is made to the ESOP. After the transaction, the equity of the business has declined by $9 million to $21 million because the company now owes $9 million to its lender. Even after discounting the ESOP portion for its minority position, the selling shareholder's 70% ownership is now worth approximately $16 million. Combined with the $9 million in proceeds from the transaction, the owner has effectively traded $30 million of value for $25 million of value.

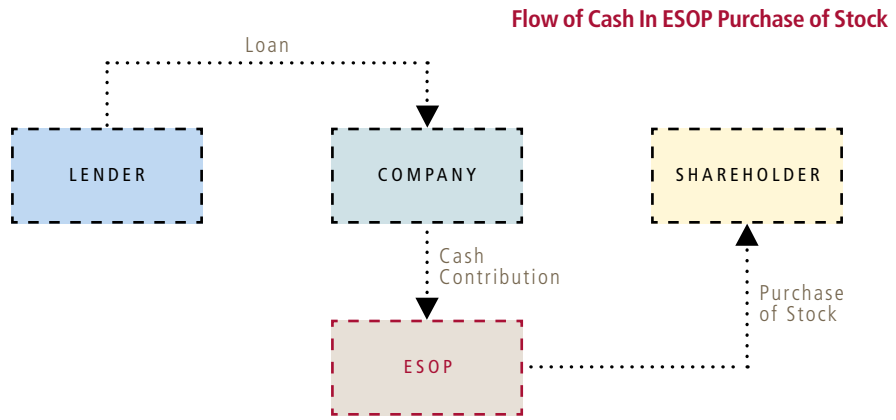
An alternative to the ESOP transaction would be for the owner to borrow $9 million and make a distribution. In this case, the owner would have $9 million in cash and own 100% of the $21 million of company equity value.

It seems obvious that entrepreneurs don't generally give away value, so the conclusion is that owners make up the value diminution in tax benefits, benefit from growth in equity value from a far more productive work force, or obtain a sales price greater than could be achieved with another buyer.

**WHAT ARE THE TAX BENEFITS?**

The primary tax benefit to a seller is the ability to avoid capital gains taxes if the com-

(continued p.3)




pany's corporate form and structure allows for "rollover" treatment of selling proceeds into a group of qualified replacement securities, known as 1042 securities. This benefit can result in a permanent deferral of capital gains tax if the proceeds are retained in the owner's estate upon death.

In the case of an S corporation, the earnings from the portion owned by the ESOP is exempt from federal income taxes as a result of the ESOP's status as a qualified benefit plan. Therefore, once the company is 100% ESOP owned, the company will no longer pay income taxes. This additional cash flow might justify a higher value to the ESOP than to other buyers.

**DO EMPLOYEES BECOME ENTREPRENEURS AS A RESULT OF AN ESOP?**

Whether or not employee productivity increases when employees own the business is a subject of continuous debate. Unless there is a reduction of some other compensation or benefit, employees do not give up anything to obtain ownership. In essence, the employees get both – their compensation program and some stock, which has value when they leave the company. Where valued by ESOP participants, the ESOP is really thought of as extra compensation.

One study is often referenced in support of ESOP companies. The study shows that ESOP owned companies earn a small differential (3-5%) more profit than comparative non-ESOP owned companies. Despite the difficulty in assessing comparative businesses, even accepting the differential as fact would not justify the economic differential of giving shares to the ESOP.

**LOSS OF CONTROL**

ESOPs are subject to Department of Labor ("DOL") and federal Employee Retirement Income Security Act ("ERISA") regulations and, therefore, bring heightened regulatory oversight and loss of financial flexibility. The rules are very rigid with regard to employee inclusion in decision-making. In this way, an ESOP is a real partner, not a sham. Decision makers for the ESOP are elected or an outside fiduciary is contracted to provide oversight and vote for the benefit of the ESOP beneficiaries.

When decisions require a shareholder vote, the non-ESOP owner(s) will find that his or her partner is governed by DOL and ERISA rules and regulations. In a decision to sell the company to a third party, the ESOP trustees will ultimately determine if the offer price is fair and pass-through voting rights will inure to all shareholders, including ESOP participants. As a result, many additional decision-makers are included in the sale process.

**A CONTINUOUS LBO**

The sale of stock to the ESOP in a leveraged transaction requires the company to borrow money. An ESOP that buys additional stock will need to borrow money for each purchase. One would think that once the ESOP owns 100% of the company and pays off its debt, that would be the end of it. Instead, vested employees begin to retire or depart and need to be bought out. The ESOP is obligated to buy out each employee after they leave the company and the company is its only source of funds. As time rolls on, the employee base continues to churn, with each person selling its shares back at market value. In essence, the company engages in a continuous leveraged buyout. This characteristic sometimes comes in conflict with the capital needs of the business.

**WHY WOULD ONE SELL TO AN ESOP?**

Many ESOPs are structured to achieve the goals of the selling owners, taking advantage of the federal tax support of this type of transaction. Anecdotally, we have observed a number of transactions in which the sale price to ESOPs has been higher than likely could be achieved in a sale to a third party. The existence of a valuation report doesn't appear to protect against that event.

In some circumstances, employees are the only, or at least the most logical buyer of the business. This is most likely true for professional service companies (e.g., engineering, consulting, architecture businesses) or contractors where people are the primary assets. In these cases, the ESOP creates an economic incentive for employees to remain with the company, reducing the inherent cost of turnover and thereby helping retain the company's most valuable assets. Also, because these types of businesses don't require significant ongoing capital investment, committing cash flow to buying out retiring employees does not overly constrain the business.

Sales to the most logical buyer can be accomplished without the use of an ESOP, but when the employee base is the most logical buyer, taking advantage of the tax code to make the transition easier makes sense to all parties. **zs**

# Aligning Shareholder Interests to Mitigate Predictable Conflicts

Direction of company and liquidity timing are the most common shareholder conflicts.

*by Mike Dannenberg*

Shareholder conflicts generally arise because the interests of shareholders do not align. Each investor in a company has his or her own time horizon, risk tolerance, and liquidity needs, which generally change with the age and personal circumstances of the individual. When these requirements conflict with what is best for the business, it is usually the business that suffers.

The purpose of a shareholder agreement is to provide a mechanism to solve the inevitable conflicts that will arise between shareholders as a result of these circumstances. Generally, these conflicts fall within two camps: the direction of the company and the timing for liquidity. The first relates to the shareholders' ability to influence the strategic direction, operating decisions, investments, personnel, and customer/supplier relationships so as to maximize value creation. Although owners might not always agree, most agreements address potential con-

(continued p.4)

flicts by clearly articulating rules for voting, board appointments, and the roles of company officers. Nevertheless, lack of common agreement on the direction of the company can lead to the second area of conflict, which is getting cash to shareholders, either through distributions or sale of interests. Rarely, in our experience, do shareholder agreements adequately deal with timing differences among owners with regard to their needs for liquidity.

**When shareholders do not align on the future direction of the company, indecision can permeate the organization, leading to a state of "paralysis" in the business, ultimately destroying value.**

When shareholders do not align on the future direction of the company, indecision can permeate the organization, leading to a state of "paralysis" in the business, ultimately destroying value.

### TODAY VS. TOMORROW

One theme we repeatedly see is the conflict between shareholders who wish to invest in the future growth of the business and those who prefer current income and/or near term liquidity.

Many shareholders in privately held businesses are accustomed to taking annual distributions, viewing these cash flows as a critical source of income upon which they have become reliant upon and are unwilling to suspend or risk it on a business transformation. This is a perfectly understandable point of view – especially if current income has been received for an extended period of time. However, in a dynamic business environment, no industry is immune from disruption, and businesses that don't continually invest will ultimately see their profits competed away. Ironically, the shareholder focused on current income is often making the riskiest choice, gambling that none of their competitors will innovate.

### THE CONUNDRUM

Unlike public securities where a liquid market exists, in privately held businesses, owners' desires to sell their stakes have important ramifications for all shareholders. For minority shareholders desiring liquidity prior to that preferred by their partners, few avenues exist to achieve their objective. Forcing the company or their partners to buy them out through the use of a "put" can create uneven risk between the selling and buying shareholders. Forcing the sale of the business or the acceptance of a new partner can also represent problems for the remaining shareholders.

The challenge is how to accommodate the desire for liquidity of a minority partner without disadvantaging the remaining investors. This is a difficult balancing act and will result in different conclusions based on the macro environment, the life cycle of the business, and the individual circumstances of each shareholder.

### AN EQUITABLE SOLUTION

The best effort we've seen attempting to accomplish this emphasizes the protection of the remaining shareholders, while providing a mechanism to pursue liquidity for the selling minority shareholder.

**1.** After a specified period of time, the shareholder desiring liquidity notifies the company that they wish to sell shares at a specific price;

**2.** The company has the first right to repurchase the shares;

**3.** If the company is not interested, all non-selling shareholders have the right to buy the shares proportional to their ownership;

**4.** If no transaction occurs, the selling shareholder can provide the board a list of potential non-shareholder parties for consideration;

**5.** Parties can be rejected for a variety of reasons, including being a competitor, having a criminal record, or being viewed as having insufficient capability to make the investment;

**6.** Management will cooperate with the selling shareholder to contact approved investors by providing a comprehensive description of the business under the protection of a non-disclosure agreement and answering questions to enable the potential investor to make a knowledgeable decision;

**7.** If any of the parties agree to a purchase at or above the seller's terms, the sale will be allowed and the party admitted into the existing shareholder agreement; and

**8.** If a party agrees to a purchase at a price lower than the seller has proposed, the offer must again be offered to the company and the other shareholders at the lower price.

This mechanism has the advantage of aligning the company and all of its shareholders by providing liquidity for minority without subjecting the company to any risk of proprietary information disclosure.

### ALIGN CAPITAL SOURCES WITH RISK PROFILES AND TIME HORIZONS

Aligning the goals of shareholders with differing time horizons and appetites for risk is extremely difficult and, in many cases, impossible. Even if there was a shared vision at one point, over time, circumstances change and generational transfers increase complexity. These situations are inevitable and almost always predictable.

Partners in private illiquid investments who do not share a common vision or objectives present a problem for everyone. The best one can do is to try and keep all shareholders aligned by providing them a logical business plan and rationale for why this direction of the company is in the best interests of each shareholder. As the time horizon lengthens, it is more likely that divergence of objectives will occur and it is in everyone's best interest to try and accommodate a solution. Often the only way to overcome these hurdles is to replace the current shareholders with alternative sources of capital whose timing and risk appetite more closely align with the requirements of the company and the other shareholders. This can allow the business to be adequately capitalized to execute on growth plans while allowing departing shareholders to invest in assets more suitable to their individual circumstances. **zs**

**Aligning the goals of shareholders with differing time horizons and appetites for risk is extremely difficult and, in many cases, impossible. Even if there was a shared vision at one point, over time, circumstances change and generational transfers increase complexity.**

## 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.**

**Brian Bergsagel**
206.838.5527
bbergsagel@zacharyscott.com

**Mike Dannenberg**
206.838.5531
mdannenberg@zacharyscott.com

**Jay Schembs**
206.838.5524
jschembs@zacharyscott.com

**Frank Buhler**
206.224.7383
fbuhler@zacharyscott.com

**William Hanneman**
206.224.7381
bhanneman@zacharyscott.com

**Kapil Sharma**
206.224.7387
ksharma@zacharyscott.com

**Doug Cooper**
206.224.7388
dcooper@zacharyscott.com

**Ray Rezab**
206.224.7386
rrezab@zacharyscott.com

**Mark Working**
206.224.7382
mworking@zacharyscott.com

Zachary Scott
TRUSTED ADVISORS

1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101