Zachary Scott has published this newsletter since 1997 to bring you a thoughtful analysis of issues affecting middle-market businesses.

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PERSPECTIVES ON THE CAPITAL MARKETS FALL 2019

IN$IGHT

Do You Really Have a Deal?

Headline is not always the bottom line.

by Jay Schembs

Business owners are inundated with letters from supposedly eager buyers of their businesses. While flattering, too much faith in an initial offer can lead to disappointment. Understanding the dynamics of a typical deal—particularly how terms and structures unveiled far down the path of negotiation can render an initial proposal unrecognizable—is essential to driving an optimal sale. As usual, we reiterate our common refrain of preparation, information disclosure, and competition to ensure the deal you expected is the deal you get.

BUYERS RESIST REVEALING TERMS

Business acquisitions involve far more than just headline purchase price. Buyers typically resist revealing critical deal terms until far down the road of negotiation and due diligence. This is in part because buyers do not initially have the information necessary to provide a more detailed proposal, but also because holding back terms allows them to be dealt with once the seller is "invested" (both literally and figuratively) in the deal. Particularly when dealing with an unsophisticated seller, it is relatively easy for a buyer to create convincing arguments as to why some new piece of information necessitates a (nearly always) less favorable change in the deal.

Besides purchase price, a number of other major deal terms can greatly alter the attractiveness of a preliminary proposal. These are discussed in greater detail below:

▪ *Structure.* What proportion of the deal is cash at closing? Is there an earnout, a seller note, an equity rollover, or a preferred position? As we discussed in "To Roll or Not to Roll," Winter 2018, private equity buyers frequently require an equity rollover, which reduces the cash at closing and is not ideal for owners seeking 100% sales. If there is an earnout, does the seller have control over the actions that will impact its achievement?

▪ *Working capital.* This represents a frequent source of bitterness in deals, as owners feel that buyers are "re-trading" to a lower price through higher levels of working capital required at closing.

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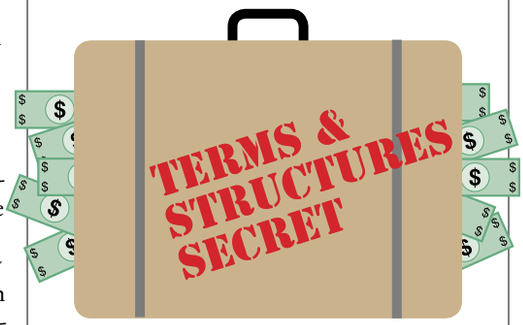

▪ *Financing.* What proportion of the capital will be debt versus equity? Is the deal contingent on sourcing capital? If the seller is reinvesting equity, will that equity enjoy the same terms as the buyer's?

▪ *Fees and Expenses.* Are the parties treated equally in handling transaction expenses? Many private equity firms require the company to pay all expenses of the buyer, but not the seller (when rolling over equity) and commit the company to pay the private equity firm management fees. All of this may be acceptable, but is sometimes hard to swallow when learned at the last minute.

▪ *Post-closing involvement.* How long, and in what role, is the seller expected to remain involved in the business? Again, for owners seeking retirement and a 100% sale, preferences regarding involvement after closing can be a rude awakening.

▪ *Keeping the purchase price.* How much and how long is the indemnification period? Are there reasonable limits on indemnity obligations? What is the amount and duration of the escrow? How much is the deductible?

▪ *Promises about the business.* Are there dangers lurking in the representations required of the seller (see nearby "GAAP, the False Prophet")?

HYPOTHETICAL EXAMPLE

An extreme hypothetical example illustrates how far a deal can stray from the initial proposal. In this example, the seller receives a letter from a private equity firm indicating great enthusiasm for acquiring his business for $75 million. The owner finds this very attractive and can't wait to spend that money purchasing his own private island. The graphic on the following page shows how the deal morphs (the blue bar represents the reducing amount of cash at closing) over time with initial terms replaced with alternate structures favorable to the buyer.

Wasting no time, the owner signs a brief document agreeing to grant exclusivity to the buyer, which prevents the owner from speaking with any other prospective buyers during this time. Now knowing the owner has no alternatives, the buyer begins its diligence investigation. Sure enough, the buyer was unaware that 35% of the company's revenue comes from one customer, a risk many private equity firms are unwilling to underwrite (see nearby, "Customer Concentration: The Real Risks and Benefits"), or only at a lower valuation. In this case, the proposed purchase price drops to $60 million.

Meanwhile, the owner's diligent response to the buyer's information requests weakens focus on the sales team. As a result, revenue dips a bit, causing the buyer's confidence in the forecast to decline. The buyer addresses their concerns by asking for a $10 million earn-out, reducing the cash at closing to $50 million. However, the big shock comes shortly thereafter, when the buyer presents a more detailed term sheet proposing

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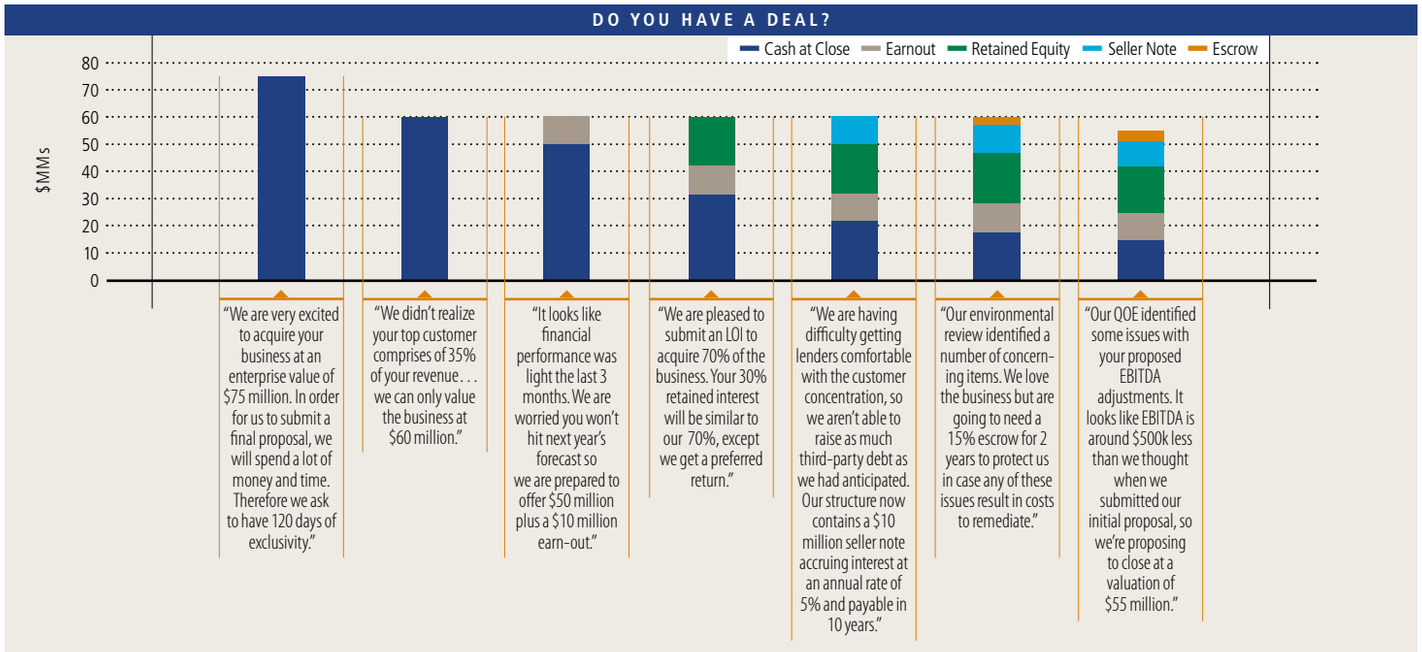

to acquire 70% of the company's equity, with a requirement that the owner reinvest 30% of his interest into the newly-capitalized business. Further, the buyer's investment will be preferred to the seller's position, which includes a preferred return as well. Cash at closing has now dropped to $35 million and the risk position of the remaining amount has increased.

But wait, there's more! Trouble raising debt financing, accounting issues during the buyer's quality of earnings investigation, and concerns identified during the buyer's phase I environmental review continue to whittle down the deal to what is now unrecognizable from the original $75 million offer. In our hypothetical example, the owner's bank account receives roughly $18 million at closing, resulting in a significantly smaller private island.

ALL DEALS HAVE ISSUES

The example presented here is extreme, but nearly all deals encounter some of these issues. To avoid these late-inning surprises, sellers would be wise to consider a competitive process that provides interested parties all relevant information necessary to put forth more comprehensive proposals. At that point, owners can then have confidence that they are getting a market deal that is far less likely to get "re-traded" prior to closing. However, running competitive processes without expert help is not easy. It is extremely time consuming, which risks distracting a seller's team from the day-to-day business.

Preparation and competition are the keys to achieving the best result. Keeping the interested party at bay while taking the time to prepare properly is difficult, but has paid off over and over for the patient and disciplined. **zs**

GAAP, The False Prophet: Avoiding Working Capital Accounting Arbitrage

How to protect against unintended consequences when a dispute occurs.

by Mark Working

Private business acquisitions nearly always express valuation in terms of a cash-free, debt-free value, subject to a target amount of working capital. The concept of a target amount of working capital and an adjustment mechanism makes conceptual sense: the date of close shouldn't introduce artifacts to a deal that are solely dependent on time and date, and both buyer and seller agree that neither party should be disadvantaged economically as a result of when a deal closes. We have written before on the challenges of determining an appropriate target (Reconciling Purchase Price and Working Capital," Winter 2006, and "Post Closing Adjustment Redux," Spring 2015), but this article is focused on how to protect against unintended consequences when a dispute occurs.

COMMON LANGUAGE OF A WORKING CAPITAL TARGET

Working capital targets are common in purchase and sale agreements. Generally, a target is established by agreement between the parties, often as an historical average to take into account the cash cycle of the business, and typically is embodied in the agreement as a number. The reason for a specific number is to avoid having someone later rethink the basis for the target. Measurement of the target is defined in terms of specific asset and liability accounts, often accompanied by a schedule showing the calculation of the target and an example as of a specific date along with the implied adjustment (positive or negative). Further, a standard for measuring the amounts in the specific accounts is established, often relying upon GAAP or even more common, "GAAP as consistently applied" in the preparation of the company's financial statements. Buyers want GAAP so the numbers can be relied on as fairly representing the actual business performance. Most companies have external accountants who have audited or reviewed the financial statements and therefore can be comfortable with the standard.

This all seems fair, but…

A WORD ABOUT GAAP

GAAP is often thought of as an absolute accounting standard that eliminates individual judgement. In reality, GAAP is a set of principles practitioners agree to follow in order to prepare statements on a comparable basis,

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which accounting regulatory bodies think will fairly represent the economic performance of the business. There are many detailed principles, but they all emanate from several core principles, one of which is that practitioners are allowed to use judgement for practical reasons to deviate from principles when they in aggregate do not materially affect the interpretation of the reported results.

In terms of determining working capital in an M&A transaction, the key takeaway is that statements in their entirety can be in accordance with GAAP while individual accounts may not be. Some notable examples:

1. Certain accounts are not reconciled monthly, but instead are trued up at the end of an audit period. Frequent examples include vacation payable, bonus accruals, and 401K contributions, none of which may be material depending on the size of the business.

2. Reserves for receivables may not be recorded with accuracy at the end of each month, but are established through a rigorous process at fiscal year end.

3. Warranty obligations may be expensed as paid as opposed to the establishment of a reserve in every period.

4. Inventory counts and valuations may not be conducted monthly (or daily in the case of a mid-month close) and reserves for out-of-date or slow-moving items may not be rigorously applied, especially for companies with large SKU counts.

ACCOUNTING ARBITRAGE

The purpose of a target is to establish the amount of working capital a buyer needs to support the operations of the acquired business. It is not to deliver a dollar amount of working capital. To that end, sellers should ensure documentation doesn't allow accounting arbitrage, applying different standards to the closing working capital amount than those used to establish the target.

Shortly after closing, the buyer calculates the actual amount of working capital as of the closing date (in accordance with the standards dictated in the purchase agreement). Especially with a mid-year closing, the buyer's accounting firm will likely "cleanse" the balance sheet to conservatively establish each account with the appropriate reserves and balances, all of which will be in "accordance with GAAP." If there is a disagreement between the parties, an accounting arbiter may be brought in to make a final determination.

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This is where GAAP can become the enemy of the seller, as the buyer is trying to obtain a specific dollar amount of working capital, and the seller is trying to convince an accountant that GAAP doesn't matter and is not appropriate for the measurement. The actual language of the agreement is critical in determining the outcome.

SOME GUIDANCE ON DOCUMENTATION

- The target should be a fixed number, with a schedule provided illustrating how the target was determined. If an average of periods, a schedule should show the account balances in each period and how the calculation was made.

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- The financial representation should be for the statements in totality, specifically calling out that judgments of materiality may have been made in individual accounts that could cause those entries not to be in accordance with GAAP. Therefore, the buyer doesn't get two chances to win the argument—first on a working capital adjustment, and if not successful, a GAAP compliance representation breach.
- The standard for measuring closing working capital should be that the closing balance sheet conforms exactly with the accounting policies and procedures used in preparing the statements when determining a target.
- If there is a dispute, the arbiter should be required to rule specifically in accordance with the language of the agreement and not any independent standard of presentation, regardless of GAAP conformance.
- The arbiter should rule separately in each individual account and not give an opinion as to the appropriate amount of working capital.
- Should an account balance be ruled to have changed, that change should be reapplied to all periods used to establish the target, including the immediately prior period, with the target being recalculated with these changes. For example, if a mistake is found where a double counting of an asset was recorded and that mistake had not been noticed since the previous audit, then the mistake should be fixed for all periods and the target recalculated.

PREVENTATIVE CARE IS BETTER THAN SYMPTOM TREATMENT

Post-closing working capital disputes can involve significant dollars, so deal documentation needs to have belts and suspenders. No claim is the best outcome, the odds of which greatly improve through good accounting practices. Before going through a sale process, the accounts should be scrubbed (and restated if necessary) for several years on a monthly basis. An outside accountant should be engaged to review policies and procedures to identify weak points. If there is to be a Quality of Earnings review conducted as part of the buyer's due diligence, a working capital account review should be considered as part of the scope.

No matter the amount of working capital in a business, unfavorable adjustments are always disappointing. It is best to head these off through preparation, but also to make sure documentation assures that fights, should they occur, are about shortfalls in value and not accounting arbitrage. **zs**

Customer Concentration: The Real Risks and Potential Benefits

There's more to concentration than a revenue pie chart.

by David Working

Business owners often spend years developing deep relationships with key customers, and many owners can point to a single customer that was the catalyst for a pivotal growth stage in their business's history. But when it comes time for the sale of a business, suddenly potential buyers start to view those relationships as a source of risk instead of strength. "Customer concentration," where a meaningful portion of sales come from a single customer, is rarely viewed as a positive characteristic. It is our view, however, that not every concentrated customer base is the same under the hood. Helping buyers understand these differences can keep engagement levels

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high, and can positively influence transaction value.

Customer concentration is a relatively easy reason to pass on an investment. A buyer will view any externality as a potential risk to a business, and customers are an externality that can be difficult to understand and predict. When a business is dependent on a small number of those outside actors, any insulation the business has against freak events becomes very thin. Unless a buyer has a great reason to spend time understanding the nature and depth of a business's customer relationships, when faced with meaningful customer concentration (usually 30-50% of sales to a single customer), it is an easy decision for a buyer to choose to spend their time elsewhere.

However, simply looking at revenue figures doesn't always tell the whole story. Assessing risk is difficult, so buyers lean on proxies of risk to help them make timely decisions, especially early in a process. If a buyer can be helped to understand why the true risk is not accurately captured in a "sales by customer" table, then they are likely to keep engaged further into a process, maximizing the perception of value and the likelihood of participating as a competitive bidder. The following case studies are examples of where the "real" risk of a revenue base was not reflected by its relative distribution of customers:

1. *Identifying the true customer.* A business was selling a technical product into pharmaceutical companies' research and development departments. On the surface, revenue appeared heavily concentrated – over 80% came from a single pharma company. But its true customers were research groups, who controlled their own budgets and purchasing decisions, and operated independently from each other under the same corporate umbrella. Within this key customer, sales were made to more than 25 research groups across multiple disease areas and business units—each with its own unique dynamics and risk profile. In this case, referring to the corporate parent as the "customer" didn't capture the true concentration, and the customer diversification was in reality quite broad.

2. *Mutual dependency.* Another business, a consumer products distributor, had developed a 15+ year relationship with its key customer, a national retailer. This customer represented more than 85% of the business's revenue. Many businesses having this characteristic would be highly risky, as they would be one of many undifferentiated service providers selling to a customer with tremendous buying power and low switching costs. Instead, in this case, the national retailer was deeply dependent on this distributor for a key segment; the two companies had spent years entwining their supply chains, information systems, and risk sharing, and had created a very high margin result for each. No competitor offered a possible substitute to the large retailer. Given these attributes, this distributor could point to its key customer as a source of strength, not risk.

3. *Immediate vs. end customer.* A third business is a counter-example, as it appeared highly diversified on the surface, yet was much riskier than at first glance. This business was a supplier of tooling and parts to a broad base of aircraft maintenance organizations across the United States. But a deeper dive into its products' end use showed that over 70% of its parts and tooling were used to service a single Boeing airframe. While its immediate customers didn't appear to show meaningful concentration, in reality, the business had significant exposure to the future of a single product line from one OEM. In this case, the traditional measure of customer concentration did not capture the true revenue risk.

Customer concentration is a relatively easy reason to pass on an investment. A buyer will view any externality as a potential risk to a business, and customers are an externality that can be difficult to understand and predict.

A business in a sale process can avoid failing buyers' early filters and can maximize the universe of attracted buyers by carefully defining its customers and characterizing its customer relationships, thereby increasing the likelihood of competition deeper into the process.

The common theme in each of these case studies is that defining the true "customer"—the owners of the end use case, the purchasing decision, the budget, or all of the above—and putting each of a business's customers in context with its own end market, competitors, and suppliers uncovers the inherent risk of the business's revenue base.

An interesting case study that is playing out in our marketplace is buyers' treatment of a business's significant exposure to the Amazon marketplace. For many private equity buyers, these businesses are excepted from customer concentration rules, as it is not believed to be the same source of risk that another dominant customer may represent. Amazon is less viewed as a customer and more as a channel, since the thinking goes that Amazon doesn't view a supplier as a supplier in traditional terms. Amazon doesn't restrict itself to certain suppliers or lock in contracts; any product that sells is as good as any other product. To a private equity buyer familiar with the Amazon marketplace and its dynamics, heavy concentration within the Amazon channel is a risk that doesn't preclude a business from deeper analysis.

While a quick look at a pie chart of "revenue by customer" shows the tip of the iceberg, it often does not answer the question that buyers are really asking: how risky is this company's revenue? A business in a sale process can avoid failing buyers' early filters and can maximize the universe of attracted buyers by carefully defining its customers and characterizing its customer relationships, thereby increasing the likelihood of competition deeper into the process. **zs**

ABOUT ZACHARY SCOTT

Since 1991, Zachary Scott has assisted owners of privately-held businesses in the greater Pacific Northwest to plan and execute major business or ownership transitions through three service lines: sell-side M&A, acquisition and investment advice, and direct investing. For more information on Zachary Scott, go to **ZacharyScott.com.**

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