

FOR EXECUTIVES SEEKING TO BUY, SELL, OR RECAPITALIZE BUSINESSES

Beware Of The Private Equity Buyer

What Business Owners Need To Watch Out For When Dealing With PEGs

One of the biggest obstacles to deal making for mid market companies is the lack of financing. With SBA guaranteed funding being capped at \$2M, doing deals north of \$3M with individual buyers becomes a challenge. Some businesses can find synergistic corporate acquirers but that is not a likely outcome for many businesses. Depending on their situation, business owners need to [determine if Private Equity is the right option for the company](#). Here is where the business owners may find out that the Private Equity Groups (PEGs) can be saviors. For many mid-market companies, acquisition by a PEG is the most realistic exit.

While PEGs can be saviors for business owners, sellers have to be very careful in dealing with PEGs. Once the business owner determines that a PEG is the right option for liquidity, he/she has to be keenly aware that PEGs are in the business of buying and selling companies. A lot of what PEGs do is financial engineering and PEGs are extremely sophisticated and savvy in making deals that are beneficial to them. Many PEGs, in spite of being private "equity", resort to debt extensively to facilitate transactions. Debt in the deal could mean financial conditions in the acquisition which increases the uncertainty in the deal.

Deals with PEGs are generally far more complex than those done with individual acquirers or synergistic strategic acquirers. Given the intricacies of the deal, and to combat the experience of the PEG, business owners need to have [a deal making team](#) of their own to ensure that the PEG does not take advantage of the business owner. From our experience, here are some common things that business owners need to prepare for when dealing with a PEG:

Preparations

- Clean up the books and have the financial statements recast and proper pro-forma financials developed. Make sure that forecasts are not overly aggressive and especially avoid underperforming the plan during the course of the deal.
- Be prepared for due diligence and review all material issues to catch any problem areas early in the process. Late surprises can have a dramatic negative impact on deal value and in some cases kill the deal. Even a minor due diligence item is likely to be used to aggressively drive down the deal value or introduce conditions that are onerous to the owner.
- Remember that due diligence can go both ways! Check the PEG's reputation and how they have transacted prior deals. Is the PEG a good match for the seller? If the deal requires the seller to stay on post-close, the seller should contact the owners of the

businesses previously acquired by the PEG to understand their perspective on working with the PEG. If the PEG is not a match, it may make sense to walk away early before expending too much time interacting with the PEG.

- Without a competitive environment, a PEG, or anyone else for that matter, is unlikely to pay top dollar for the company. To strengthen the negotiating position, make sure the [M&A advisor](#) is pursuing all possible angles to cast the widest possible net.

LOI

- A PEG could easily lock up an inexperienced seller with a basic LOI and drain the seller with a drawn out negotiating process. A comprehensive LOI reduces back end negotiating and is to the seller's advantage.
- Negotiate key terms of the deal in the LOI. This is where the seller has the maximum leverage. Depending on how well the [M&A advisor](#) orchestrates the deal, this is when the acquirers perceive competition and do the best they can to get what they want. Once the LOI is signed, the leverage starts shifting and the longer the deal takes to close, the more leverage the PEG is likely to gain.
- If the deal is a competitive deal, try to resolve as many key terms as possible before choosing which LOI to accept.
- While LOIs in general are non-binding, there could be specific elements that are binding. Watch out!

Deal Terms

- If at all possible, get a stock deal. The advantages are many and in most cases are well worth taking a lower valuation to compensate for the tax disadvantages of the buyer.
- Whether a stock or asset sale, ensure that the [M&A advisor](#) and accountant work closely to make the deal as tax beneficial as possible. Tax issues could have a dramatic impact on what the seller gets to take home. So, leave no stone unturned!
- For a stock deal, make sure there is a "basket" clause in the LOI to avoid being nickel and dimed on non-material post-close liabilities.
- In a stock sale, get agreement to cap the potential post-close liability to a reasonable percent of the transaction value. This clause must be in the LOI because it can be much tougher to get it in the acquisition agreement once an LOI lacking it has been signed.
- Watch out for financing conditions in the LOI. In today's tight credit environment, financing conditions introduce a potentially risky and sometimes unacceptable delay to closure.
- Be very cognizant of the debt, equity tradeoffs. Keep in mind that the seller is selling an equity share and not taking out a loan.
- If possible, get a "non-reliance" clause to prevent the buyer from suing seller post-close based on oral statements and other things that are not part of the written acquisition agreement.

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