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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, business owners 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 the name 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. There is a high premium attached to not underperforming the plan during the course of the deal.

- Be prepared for due diligence. Review all material issues and problem areas early in the process. Late surprises can have a dramatic negative impact on the deal and in many cases kill the deal. Even a minor diligence item may 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 sale 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 deal 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.

- Look for 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.

- If possible, get the PEG to sign off on a termination or "break-up" fee if the deal falls through for any reason other than seller's non-performance.

Negotiations

- PEGs are extremely disciplined about the process. Sellers get emotional at their own risk! Emotions during the deal can be easily exploited so it is better to let the deal makers interface regarding deal points without exposing the seller's emotions.

- Without competition (or the perception of it), a PEG will seize the opportunity to exploit deal issues for monetary gain. As the deal draws out the PEG knows that the seller has already spent a considerable amount of time and money on the process and without competition for the deal the PEG has an upper hand.

- If the deal is getting bogged down, brainstorm with the negotiating team and look for creative ways to get the desired outcome. It may be difficult to salvage a deal if the positions are too entrenched and/or emotions take hold. Creativity and objectivity are key ingredients to good deal making.

- A PEG will have multiple members of their team working on the deal. Watch out for the good-cop, bad-cop routine. Without sufficient care, it is easy to end up making multiple concessions during the process without getting much back in return. Having the deal terms handled by an M&A advisor is an easy way to avoid this problem.

- When dealing with multiple PEGs, keep in mind that each deal is different - different players, different negotiating leverage, different risks, and different timing. Strategize a plan specific to each PEG with the advisory team. Be keenly aware of the seller's personal limitations, deal-breakers, and wish-list, and the amount of time and money that is being consumed in the deal making process.

Summary

While PEGs can be a boon for mid-market sellers, it is imperative that the sellers understand that they are dealing with a professional buyer. A good advisory team, careful preparation and negotiating skills are necessary to maximize the benefit. Sellers beware: One line in the contract can make the difference between a good deal and a bad deal.

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