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Fox Rothschild Podcast

Featuring Partner David Jaffe in Pittsburgh

Private Sellers, Public Buyers: Straight Talk About Selling to a Public Company

We are talking today with David Jaffe on Fox Rothschild Podcast. David is a partner with Fox Rothschild in Pittsburgh. He advises clients on corporate finance, mergers and acquisitions, restructuring and corporate governance. David recently chaired a panel discussion of the Association for Corporate Growth on selling private companies to public buyers.

***Question**: David, welcome to the podcast.*

David Jaffe: Thank you.

***Question**: David, as we near the end of 2012, what do you see as the state of middle market merger and acquisition activity?*

David Jaffe: Lower middle market deal activity slowed substantially in the fourth quarter despite improvements in the debt markets. Many of my investment banking friends tell me that pitch activity was down and multiples for completed transactions were lower.

In my view, the presidential election was a bit of a "red herring" inasmuch as everyone knew that the so-called "fiscal cliff" issues weren't going to be resolved without a period of further uncertainty after the election. That said, there's reason for optimism in 2013 once we get past those issues.

***Question**: David, when M&A buyers and sellers decide to transact, what are the macro-level factors that influence their decision-making?*

David Jaffe: On the buy side of the equation, companies might decide to pursue inorganic growth strategies (or growth by acquisition as it is known) for a number of different reasons – some economic and some strategic. Corporate acquirors have experienced an increasing accumulation of cash on their balance sheets as a result of U.S. fiscal policy over the last several years combined with a reluctance to make long-term capital investments until future risks are better understood. Private equity investors are experiencing their own version of this "excess liquidity" problem in the overhang of un-invested capital being experienced by many funds.

Strategically, a variety of factors might lead a corporation to pursue acquisitions – including for example the need to acquire intellectual property assets or human capital, product line extensions or competitive dynamics in the industry.

***Question**: David, what do you see as some of the main catalysts on the sell side?*

David Jaffe: Again, the decisions are highly contextual. But as a general matter, private companies are often sold when there is a personal need for liquidity by the owner/operator. This can happen at a time of generational transition in a family business or when the shareholders feel a need to diversify their risk.

On a strategic level, companies often consider an exit transaction when competitive threats emerge that they feel better equipped to address with a better resourced partner. These can be competitive threats from a lower cost producer, or because product liability, environmental risks or increased regulation in the industry are leading to higher litigation risks and expenses.

***Question**: David, what are some of the common attributes that make private companies attractive acquisition targets to public companies?*

David Jaffe: Purely from a corporate finance perspective, public companies often look to acquire private targets because market inefficiencies in the private market and informational asymmetries can make these kinds of acquisitions accretive and highly profitable to a public buyer. An example of this is seen in so-called "roll up" transactions where industry fragmentation, among other characteristics, enables a well-capitalized public company to aggregate through acquisition numerous smaller privately held companies into a consolidated and more valuable unitary enterprise.

From a strategic perspective, public buyers make acquisitions of private targets as part of a rational decision-making process where speed is a priority and they determine that inorganic growth is going to be faster or has a higher return on investment than organic growth. This is the so-called "buy verses build" dichotomy. Variations of this include corporate acquisitions to gain entry to new markets or for example to extend a product line.

***Question**: David, what are some of the unique challenges that come to light in public acquisitions of private companies?*

David Jaffe: Public on private deals have an array of unique nuances compared to other types of M&A transactions. Much of it stems from cultural differences and differences in the manner in which private and public companies are operated.

***Question:** David, can you give the listeners some examples of what you are talking about?*

David Jaffe: Sure. Two areas that exemplify the contrast between public and private companies are in the management decision-making process and in governance. With respect to decision making, private companies are often characterized by informality, speed and the dominance of one or a few individuals. Public companies, on the other hand, make significant business decisions by consensus and with sensitivity to all of the internal stakeholders in the management hierarchy within the organization.

***Question:** Can you elaborate a bit?*

David Jaffe: To a large degree, this difference in decision making is driven by the more fundamental underlying difference in governance structure. In a public corporation, because the share ownership is widely disbursed among public shareholders, ownership and managerial control of the corporate enterprise are separate. Directors and officers of public companies have very significant obligations in the form of fiduciary duties that they owe to the shareholders. This accountability leads to a level of

intentional redundancy and bureaucracy in corporate decision-making. So, directors and officers are somewhat more risk averse and deliberate in a public company context.

Conversely, and largely due to the absence of the bifurcated structure I just described, privately held businesses can move faster and are often willing to assume more risk.

***Question**: David, what about differences in organizational development?*

David Jaffe: This is another area that illustrates this cultural dichotomy very well. Private companies often have a less well-developed management team. They have fewer management personnel so each individual may have a larger portfolio of responsibilities than his or her public company counterpart. In an acquisition context, this can lead to significant tensions between the parties during due diligence and negotiations because more and more of seller's management's time is being diverted from operating the business to getting the deal closed.

***Question**: David, how should a private target begin preparing for or even thinking about an exit?*

David Jaffe: In my view, the first step in any M&A transaction is to determine whether the seller has a credible and realistic sense of what the company is worth. This has to be an objective, market driven assessment of value, it can't be wishful thinking. In my experience, of all the reasons that transactions fail to close, the most common is that the valuation expectations of seller and buyer are so far apart that there is no realistic chance of bridging the gap.

But once the owner/operator has a clearer view of how his pricing expectations match up with the market, a preliminary determination can be made about whether or not to pursue a transaction.

***Question:** So David, what are some of the key sticking points or "disconnects" that you see between private and public companies on valuation?*

David Jaffe: Most private sellers have a general idea that their company will be valued as a multiple of EBITDA. This acronym, which is a proxy for cash flow, stands for "earnings before interest, taxes, depreciation and amortization." EBITDA implies by its very name that certain non-cash expenses will be added back to earnings to arrive at an approximation of actual cash flow. What sellers frequently fail to realize is that the EBITDA calculation is merely the starting point for negotiations. Because public buyers will want to acquire the company on what is known as a cash-free, debt-free basis, but with a level of working capital that is sufficient to operate the company without external financing for at least one full business cycle.

***Question**: David, what are the implications of a cash-free, debt-free structure on the seller?*

David Jaffe: If there is long term debt on the seller's balance sheet, or significant capital expenditures that need to be made, or a shortfall in working capital, the buyer will be unwilling to assume those risks. The net effect of this will be a reduction in the proceeds of sale available to the seller – either by virtue of sale proceeds being used to satisfy those items or by virtue of the price being reduced if the buyer is to satisfy them. So, once the seller fully appreciates the impact of these "adjustments" on the EBITDA calculation and on the price, the deal may not look as attractive to the seller as it did at the outset.

Question: *David, tell our listeners a little bit about the transaction process and due diligence in particular.*

David Jaffe: The first point I want to make is in reference to my earlier comment on the deliberateness and risk aversion of public buyers. Private sellers need to anticipate an exhaustive and thorough due diligence process by the buyer and its advisors. They will seek to uncover every risk of a material nature. Sellers should also know that due diligence is multifaceted. It covers legal, operational and financial aspects of the business. So the sellers are well advised to have their corporate records organized, complete and available for easy inspection. By "corporate records," I'm referring to contracts, financial statements, tax returns, employee files, insurance documentation, litigation files – anything and everything germane to the business. It is a very comprehensive process.

Question*: David, is due diligence typically conducted as a cookie-cutter approach?*

David Jaffe: I wouldn't' say it's cookie cutter, I would say it's formulaic. If the transaction is an all cash deal, the due diligence will mostly be a buyer-driven process with the seller being under the microscope. But, if the transaction is structured in a manner where the seller is holding risk in the form of non-cash consideration of any type (an earnout, a promissory note or buyer's stock), then it will be a bilateral process because the seller will need to have a good feel for the buyer's risk profile.

If the buyer is a public company, a significant amount of information will be available in the public domain. But, there are very significant limits on the seller's ability to rely solely on public information in its due diligence investigation of a public company buyer.

Again, roll up transactions demonstrate the limits of relying on public disclosure. Where the public buyer has acquired numerous small privately held companies, individual transactions may not have been disclosed if they fell beneath the public buyer's materiality threshold. Yet, the transactions in the aggregate may well be material to the buyer. Furthermore, any particular acquisition may contain terms that will have an impact on the seller's deal with the buyer.

Question: *David, can you give us an example"*

David Jaffe: If for example the seller holds subordinated debt in the buyer's capital structure, which often happens in the acquisition of private companies, the seller will want to quantify the amount and character of the buyer's debt – how much is senior to seller and how much is *pari passu* or subordinate to the seller. But this information may not be publicly available if the buyer's previous acquisitions were below the materiality threshold.

Question: *How do the results of due diligence affect the actual transaction terms?*

David Jaffe: This is a really important question. It's important for sellers to understand that due diligence is not merely an academic exercise. It has tangible financial consequences in the following manner.

The seller needs to realize that at the same time the buyer is conducting its due diligence review, it's also writing the acquisition agreement. The scope of representations and warranties that the seller will be required to give in the agreement will depend in large part on the buyer's due diligence findings. The representations and warranties are backed up by the seller's indemnification obligations in the acquisition agreement. Those indemnities are funded by clawbacks and reserves which reduce the purchase price.

So, if due diligence produces unanticipated liabilities or risks, they will be reflected, ultimately, in the seller's indemnity obligations. Similarly, if the seller's records are deficient or are not transparent or if the seller is uncooperative in due diligence, those gaps will be reflected in the indemnities. Through the risk-shifting devices in the acquisition agreement, these due diligence risks will ultimately reduce the seller's proceeds after the deal is closed.

***Question**: David, are there other issues in diligence that are important in an M&A deal?*

David Jaffe: I think it's important for the principals on either side to make efficient use of their advisors during due diligence and in transaction negotiations. In many deals, the relationships between the buyers' and sellers' principals will need to endure for a considerable period of time after the closing, often for many years. This is the case for example when the seller has significant value locked up in an earnout that will be released over a period of years or where the seller's management and owners have employment relationships with the buyer following the closing.

Because due diligence and negotiations can become contentious at times, in the interest of preserving their direct relationships with each other, the principals should consider stepping back from the table and allowing their advisors to work through those sensitive issues.

***Question**: David, when a deal is about to close, what do you see as the prime factors affecting a public buyer's speed to and certainty of closing?*

David Jaffe: For starters, it's really important for sellers to consider closing risk very carefully and thoughtfully when evaluating potential acquisition partners. Many times, in the fervor to get a deal done, this is an area that gets overlooked and not all buyers are created equally. Aside from the diligence process, which we've already discussed at some length, there are several other issues that can increase closing risk. An issue of particular sensitivity to public buyers is SEC review of the transaction.

If securities are being issued to the sellers or, even in an all cash deal that meets one of the materiality thresholds under the federal securities laws, the buyer will need to include in its SEC filings *pro forma* and historical financial statements of the private target company. These financial statements have to be audited and have to be prepared in accordance with generally accepted accounting principles to meet the SEC standards. If the private company has not historically prepared audited financial statements, and many of them don't, then the amount of time required to retroactively audit prior years can result in substantial delays in the SEC review or disclosure process and hence, the closing. So, part of a seller's "pre-deal" preparation should include engaging an audit firm to prepare audited financial statements.

One final closing risk that bears mentioning, and is generally applicable to buyers of every stripe whether public or not, is where the transaction contains a financing contingency. Sellers should thoroughly evaluate the financing commitment obtained by a buyer and seek reasonable and specific limits in the definitive acquisition agreement on the buyer's walk away right for a failed financing condition.

***Narrator**: Well, David, thank you. Listeners, to discuss the opportunities and risks of a potential merger or acquisition, please contact David at 412-391-6410 or at djaffe@foxrothschild.com.*

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