Fox Rothschild Podcast

Featuring Partner David A. Jaffe

We're talking today on FoxCast with David Jaffe in the first of two discussions about selling a family owned business and the importance of selecting trusted, competent advisers. David is a partner with Fox Rothschild in Pittsburgh. He is a business transactions lawyer whose practice focuses on mergers and acquisitions, growth capital investments, corporate finance, corporate governance, securities offerings and distressed company transactions. David also posts on the firm's "Emerging Companies Insider" blog. David, good morning.

David Jaffe: Good morning. Good to be here.

***Question**: David, you've counseled a lot of families over the years in the sale of their business. I suspect that must pose some really interesting dynamics.*

David Jaffe: Yes. For most owners, preparing to sell the family business is the single most important undertaking of their professional lives. The company is the economic engine that's sustained the family for decades or maybe even for generations. So many families have a very significant portion of their wealth concentrated in the business and therefore in largely illiquid form. Of equal or greater importance than the economic considerations is the fact that the family firm is often the social and cultural anchor for the extended family.

***Question**: There really is a strong emotional component to the process, isn't there?*

David Jaffe: Absolutely. In a family business enterprise, family history, personal relationships and money converge to make the decision to sell much more than an exercise in cold, objective business rationality. It is, and should be, a highly personal and emotional experience — and that's precisely what makes the role of advisers so critical to achieving a successful outcome. Given the strong mix of emotions that are swirling around in the minds of the family members, advisers are there to provide objectivity, stability and rationality along the way.

***Question**: When deciding to sell, should the owner of a family business even try to go at it alone? I mean, they know the business better than anyone. Or should they trust an outside adviser to help, such as an investment banker? Doesn't that get expensive?*

David Jaffe: There's no question that nobody knows the business as well as the owners. But that's the crux of the problem. Owners often are *too* close to the company to see it objectively as a buyer will. This prevents the owner from seeing the risks and other value-detractors that, if they're identified early enough, can be remediated in time so that they don't impact value. So, an

owner can obtain crucial advantages by choosing an investment banker who'll be the advocate during this important process. But it's critical to bear in mind that advisers have their own biases as well.

Question: *What do you mean?*

David Jaffe: Transaction professionals, whose compensation hinges on closing successful deals, bring an inherently pro-transaction perspective into the mix. And this is what happens with investment bankers. But sometimes, depending on the circumstances, the best transaction might be no transaction at all. I think on balance, though, despite this pro-deal bias, investment bankers add invaluably to the sale process. The keys for a seller are in knowing when and under what circumstances to engage a banker and how much weight to give their advice in the overall mix of views that the owners are soliciting.

Question: *How are investment bankers paid?*

David Jaffe: Generally, investment bankers who are engaged by sellers receive a "success fee," which is based on a percentage of the consideration that's paid in the transaction. They're usually paid on a declining scale (which is known as the "Lehman" scale) inversely proportional to the overall price. So as the price increases, the banker's fee as a percentage of the value of the deal decreases. Often they receive a retainer also at the outset of an engagement, all or part of which will be credited against the back-end success fee.

Question: *Do you know of any horror stories about business owners who tried to sell the company themselves?*

David Jaffe: I wouldn't say that there are horror stories *per se*. It manifests itself typically either in deals that don't close or deals that close at the wrong price. In the former case, unconsummated transactions often are the result of irrational and untested expectations of what the company is worth held by the seller, held by the family. In the latter case, the seller will find out after the fact that they left money on the table because either they didn't understand the company's true worth or they didn't understand that there were extrinsic strategic factors that sometimes play into buyers' decisions.

Question*: Are there scenarios where it is appropriate to consider hiring an investment banker?*

David Jaffe: I think there are three scenarios I'd like to mention in this podcast. The first is where it's a "seller's market." Markets go in cycles and investors often exhibit a herd mentality insofar as any particular industry is deemed to be in or out of favor. So in a given industry, a seller's market occurs at that point in the cycle when the number of available companies for sale is fewer than the number of buyers seeking to acquire companies. Along with this imbalance, there are other telltale signs that indicate when a particular sector is heating up. Increased press coverage of large investment or financing transactions, increased IPO activity, a larger than normal volume of market entrants, increased lending activity in the industry or in adjacent

sectors are all hallmarks of a frothy market. In this environment, it's wise for a seller to consider engaging an experienced pro who can leverage buyer demand into a bidding war for the company. And this is almost always likely to result in a higher price under sellers' market-type conditions than a proprietary, one-to-one negotiation undertaken directly by the seller.

***Question**: So a "seller's market" is one scenario. Are there more?*

David Jaffe: A second scenario where a seller can benefit from engaging an investment banker is when the company has had a sustained period of steadily increasing financial performance. Revenue growth is always an essential metric in almost every industry. Depending on the sector, growth in profits, EBITDA growth, may or may not be a prerequisite to attract buy-side interest. If a company is in the enviable position of having *both* dramatic revenue growth and profit growth, it's probably been receiving unsolicited acquisition interest. It's natural for an owner in this position to believe that he's capable of navigating negotiations by himself.

***Question:** What's your view on that?*

David Jaffe: This is precisely the situation in which overconfidence and inexperience can kill the deal. The prudent owner should step back, because for all his or her virtues and business knowledge, they're treading on unfamiliar territory usually when it comes to selling the company. If you've never sold a company before, you'd be wise to surround yourself with professionals who've done so. The right banker will know the markets in which the business operates, what the buyers are looking for and how to position the company within the overall context of the industry and the buyer's business strategy.

***Question**: OK. So selling off of a strong sustained financial performance makes sense. Any others?*

David Jaffe: A third scenario is where a banker is advantageous to a seller is when there's a substantial disparity in the size or sophistication of the companies favoring the buyer. In the vast majority of M&A transactions involving privately held target companies, buyer and seller are in asymmetrical positions that favor the former over the latter.

***Question:** And why is that so?*

David Jaffe: Because the buyer is usually larger than the seller, usually the buyer has engaged in more transactions than the seller and the buyer has long-standing relationships with professional advisers with whom it's completed deals in the past. Active corporate buyers, for example, look at dozens of companies before making one acquisition. In that process, they acquire a lot of domain knowledge about industry sectors and niches and the relative valuations of companies within those sectors. The same holds true for financial buyers such as private equity investors, which are in business of buying and selling companies.

***Question:** What about the seller?*

David Jaffe: Closely held sellers seldom have the time or the resources to undertake a comprehensive strategic survey of their own industry. They're a lot more likely to rely on anecdotal information instead of hard data. Moreover, process dynamics usually favor buyers for a multitude of reasons. They have deeper management ranks. They have efficiencies gained from working on prior deals with outside advisors and other advantages that sellers often don't have. So even in the context where a selling company is fortunate to have experienced dramatic growth or experience of a seller's market, these asymmetries that favor buyers can overpower the seller at the bargaining table. So the right investment banking firm can be an effective counterweight to the buyer's leverage and help to level the bargaining table.

Narrator*: Well, thank you David, for this insightful overview. In the next podcast, David will provide some tips on how to interview investment banking firms to determine the best fit for your company. Listeners, to confidentially discuss the prospects for selling your company or engaging an investment bank, please contact David at 412-391-6410 or at djaffe – that's D-J-A-F-F-E – at foxrothschild.com.*

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