Fox Rothschild Podcast

Featuring Partner David A. Jaffe

We're talking today with David Jaffe on Foxcast in the second of a two-part series about the sale of family owned businesses and how to select 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 and other corporate transactions. He also posts on the firm's "Emerging Companies Insider" blog. David, good morning.

David Jaffe: Good to be here this morning.

Question*: In part one of this series, you discussed the "ins and outs" of the decision-making process that sellers undertake when considering whether to hire an investment banking firm to help them sell the company.*

David Jaffe: That's right. Part I identified three common scenarios where investment bankers can offer sellers high value. Today, I'd like to discuss in greater depth certain key questions that every seller should ask when interviewing an investment banking firm.

Question*: David, I hear more and more about the use of M&A advisers in lower middle market transactions. Has something changed to cause this?*

David Jaffe: It's a good question, and the answer is "yes." The influx of talented deal professionals into the lower middle market over the last decade has radically changed this segment. It's not uncommon nowadays to find many smaller, highly competent "boutique" M&A firms that have a deep and narrow set of sub-specialties and that are staffed with bankers who have had Wall Street experience.

Question*: With the plethora of choices available, how do sellers find highly competent advisers to represent them in a sale process?*

David Jaffe. It starts with knowing the right questions to ask. Question number one is what percentage (by deal volume and dollar value) of the firm's work is in M&A? The question is designed to elicit the banker's actual M&A experience, as opposed to experience in other types of transactions.

Question: *How so?*

David Jaffe: Well many middle market investment banks offer an array of different services – including M&A advice, corporate finance, capital raising, fairness opinions, restructuring services and other services. By asking about M&A specifically, the sellers gain some general

understanding of its relative importance to the firm's overall practice and the banker's expertise in M&A transactions as opposed to other kinds of transactions. Naturally, a seller, who's going to sell a company, wants to select an adviser with the right experience.

***Question**: Won't all investment bankers say they specialize in M&A? How does a seller sift out the wannabes?*

David Jaffe: Another crucial question is how many M&A engagements the banker led in the past two years. Industries tend to move in 18 to 24 month cycles of activity, and transactions usually take 90 to 120 days from inception to closing. So a two year look back should provide a good barometer of the firm's familiarity with emerging deal trends. This question will provide a sense of the banker's deal backlog so sellers will be able to determine the level of attention that they'll receive and the capacity of the firm's top dealmakers to take on a new sale engagement and to be able to handle it well. It's one thing for a bank to be highly sought after, but there's a delicate balance between being "in demand" and having so many deals in the shop at the same time that a seller gets lost in the shuffle or has the "B" team of the investment banking firm assigned to the transaction.

***Question**: Should a seller try to ascertain a bank's loyalties to avoid conflicts of interest?*

David Jaffe: Yes. A seller needs to understand what percentage of a bank's sell-side M&A practice is for private equity clients and other institutions as opposed to what percentage is for independent owner-operated companies.

This is a very important question because many private equity firms use the same investment banking firm to sell portfolio companies as to source acquisition targets on the "buy side." So it can present several issues for an independent seller including, among others, how the transaction will be prioritized by the banker who has a significant institutional client that sends it a lot of deal flow. What resources and personnel will the bank allocate to the transaction? How much attention will senior bankers give the deal? If questioned, the banker may tout its relationships with private equity firms as beneficial to the seller, and that may be true, but it also presents certain obstacles. When a banker receives a large share of its engagements from an institutional investor such as a private equity firm, there can be a natural, if subconscious, tendency to show preferential treatment to that client in engagements that the banker is handling for other clients.

***Question**: David, I'd like to revisit your point about "fit." Are there risks to smaller companies when dealing with larger investment banking firms?*

David Jaffe: That's a particularly acute risk in the lower middle market. A way to approach that issue is to ask about the firm's average transaction size or value of sell-side M&A engagements over the last two years and the range in size or value from minimum to maximum.

Over the past few years a significant number of investment banking firms that previously would not have considered doing smaller transactions have entered the lower middle market. A seller

should understand the importance (measured by transaction value) of his or her transaction relative to the banker's backlog of deals generally. If it's too small, then a banker might deprioritize a seller's deal in favor of transactions that are larger and more lucrative. If it's too large relative to the bank's average transaction, the firm might lack the expertise and resources to get the deal done. So you really want to be in that "goldilocks" zone where the transaction is of sufficient size and value that the banker is eager to have the engagement, but it's not so large (or small) that it takes the banker out of its zone of true competency.

Question*: David, you've mentioned in previous Foxcasts that there's a pretty large gap between a letter of intent and then a consummated deal. What is the banker's role in closing that gap?*

David Jaffe: It's huge. A seller should ask the banker very directly: "Of recent sell-side transactions, initiated in the last two years, what percentage of deals have you closed to date?"

One of the biggest concerns a seller has to address is closing risk. The M&A process takes up an exorbitant amount of management's time and bandwidth for many months. The opportunity cost of a failed deal in terms of diverted attention resources is considerable, to say nothing of reputational damage. Sometimes deals break because the market turns. Other times, deals break because they're mismanaged by a banker. Understandably, the bankers prefer like other professionals not to admit defeat, but if they've been sitting on pipeline of transactions that haven't closed over a two-year time frame, it's a major red flag that sellers need to understand but that a banker will not necessarily want to advertise.

Question*: We're just about out of time. Are there any final thoughts you'd like to share with our listeners?*

David Jaffe: Thanks. I'd leave the listeners with one final thought. Perhaps the single most important question to ask the banker is: "What percentage of its closed transactions have closed at or above the initial valuation range?"

Question: *Can you elaborate on that?*

David Jaffe: Sure. When investment bankers come to pitch sellers to obtain engagements, it's common for them to provide what's called a pitchbook, which contains preliminary (or indicative) value of the seller's company based upon financial data provided by the company and other independently derived information that the banker has access to. The bankers recognize that the pitchbook valuation has great significance to sellers because it establishes a baseline expectation of what the company is worth. Reputable investment banking firms will not submit a valuation unless they're highly confident that the closing price of the actual deal will meet or exceed the pitchbook value. Conversely, investment bankers recognize that if the indicative value is too low relative to what the seller's expectations are, they'll be unlikely to win the engagement. So, reputational risk constrains a banker on the upside, and competition for the deal constrains them on the downside. Either way, it's extremely important for a seller to be able to

gauge the banker's ability to deliver against the pitchbook valuation in the form of actual purchase price in closed transactions.

***Narrator**: Well, thank you David, for these insights. 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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