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Inside This Issue

Feature Article:

*Conventional Deal
Terms in Middle
Market M&A
Transactions*

Expert's Corner:

*Timing the Sale of a
Middle Market Business
in a Bubble Industry*

About Us:

The McLean Group is a national, middle market investment bank serving businesses generating up to \$500 million in annual revenue. For more information, visit www.mcleanllc.com.

Feature Article:

Conventional Deal Terms in Middle Market M&A Transactions

By Geoff Nattans, Senior Associate, McLean, VA

While purchase price certainly is an important component of an M&A transaction, a savvy seller in the middle market must evaluate a deal based on numerous quantitative and qualitative value components and deal structure factors. Two offers having the same total purchase price may vary significantly in terms of actual value to the seller—based on the relative risk and timing associated with payment of compensation by the buyer to the seller, as well as qualitative factors that can make one offer more or less attractive than another.

Continued on p. 2

Expert's Corner:

Timing the Sale of a Middle Market Business in a Bubble Industry

By Dennis Roberts, Principal, McLean, VA

Determining the right time to sell a business at its maximum value is not always a luxury available to middle market business owners. Factors such as plateauing sales, disputing partners and/or retiring owners oftentimes influence a company's time of sale more than its market positioning. Companies within a bubble industry, however, have the luxury to choose to sell while the market's hot, or quickly miss the opportunity to collect exceedingly high multiples.

Continued on p. 3

“Conventional Deal Terms...” continued from p.1

QUANTITATIVE DEAL TERMS

A seller would like to see most of the compensation for a transaction as cash paid at closing and, conversely, the buyer generally will want to defer as much of the deal compensation as possible. Deferred compensation most commonly appears in the form of a seller note (the seller takes on part of the subordinated debt that may or may not pay interest) or earn-out (contingent on the target company’s ability to achieve specified milestones—most commonly revenue or gross profit targets). In certain situations, most often with private equity deals, the buyer will encourage/require the seller to rollover a specified portion of the deal proceeds back into equity in the new company. Rollover equity can be an effective tool to motivate sellers remaining on the company’s management team by closely aligning the interests of buyer and seller.

While deferred compensation is not the seller’s preferred form of deal consideration, it often can be a useful tool to bridge a valuation gap between buyer and seller. As such, the seller inherently will share some of the risk with a buyer, but if an earn-out is structured appropriately, the seller also will enjoy exposure to a favorable upside opportunity.

In addition to the deal consideration mix, other quantitative negotiating points—such as escrows and net working capital thresholds—can be significant value drivers affecting seller take-home cash. The transaction escrow is the portion of the purchase price that the buyer holds back to insure against unforeseen liabilities. On average, 10% of the purchase price may be held in escrow but this may vary by industry and the specific transaction. Escrow terms and liabilities related to representations and warranties made by the seller are addressed exhaustively in the final stock/asset purchase agreement.

For stock deals, the acquiring company assumes all of the seller’s assets and liabilities at closing (please refer to the figure below for a comparison of stock

vs. asset deals). As a general rule in middle market M&A transactions, the seller conveys his/her balance sheet on a debt-free, cash-free basis, with a specified “target” amount of net working capital (typically current assets less current liabilities) remaining in the business to fund operations. To the extent that the actual working capital balance at closing is above or below this target figure, the purchase price is adjusted accordingly on a dollar-for-dollar basis. While there are many ways to determine a normal or target level of net working capital, the average working capital balance from the last 12 month-end balance sheets is the most commonly used method.

Stock Deal
<ul style="list-style-type: none"> » Buyer assumes all assets and liabilities of the seller, cleanest transaction type; » Tax treatment favors seller who can be taxed at capital gains rates; buyer cannot amortize transaction goodwill; » May expose buyer to potential unknown liabilities (legal, tax, accounting, etc.). <p style="text-align: center;">*Deal terms can be structured to mitigate this risk.</p>

Asset Deal
<ul style="list-style-type: none"> » Buyer purchases all or some of the seller’s assets, can carve out undesirable liabilities; » Tax treatment favors buyer who receives a step-up in tax basis and can amortize goodwill, seller pays ordinary income tax on a portion of the consideration; » Can be more complex—requiring more time and legal expense.

If the seller is an S-Corporation, or an LLC in certain cases, the buyer and seller can pursue a 338(h)(10) election, in which a stock transaction is treated as an asset sale for tax purposes. The selling shareholders typically experience minimum adverse tax impact, while the buyer receives a step-up in tax basis and the ability to amortize the transaction goodwill (generally

Continued on p. 3

“Conventional Deal Terms...” continued from p.2

purchase price less book value) over a 15-year period. The selling shareholders and their advisors can negotiate to receive a portion of the additional value created by a 338(h)(10) election.

QUALITATIVE DEAL TERMS

In addition to purchase price consideration and basic deal structure, numerous qualitative factors stipulated in a Letter of Intent/Term Sheet should be considered by a seller before choosing an offer. While a comprehensive analysis of each of these points is outside the scope of this article, we will explore two critical deal terms: sources of financing and employment and non-compete agreements. Strategic and financial buyers alike most often require or choose to pursue financing for acquisitions—based primarily on their cost of capital, risk profile and strategic objectives. Educated sellers should have a clear understanding of which potential suitors require contingent financing to complete a deal and which can close a transaction with cash on hand or from existing debt facilities.

In addition to investigating where a buyer will obtain the funding for a deal, selling shareholders should also understand what the buyer expects from them post-transaction. Buyer expectations as to the role a seller will play going forward will vary drastically from deal-to-deal, but sellers who intend to stay on-board as members of the management team generally will be required to sign employment agreements that specify term and compensation and/or non-compete agreements (which also are common for selling shareholders who will not remain as part of the management team). In every case, the seller should evaluate the value and potential opportunity cost in each proposal within the framework of the seller’s personal ambitions and goals—to include such important factors as time with family, new business ventures and planning for retirement. ♦

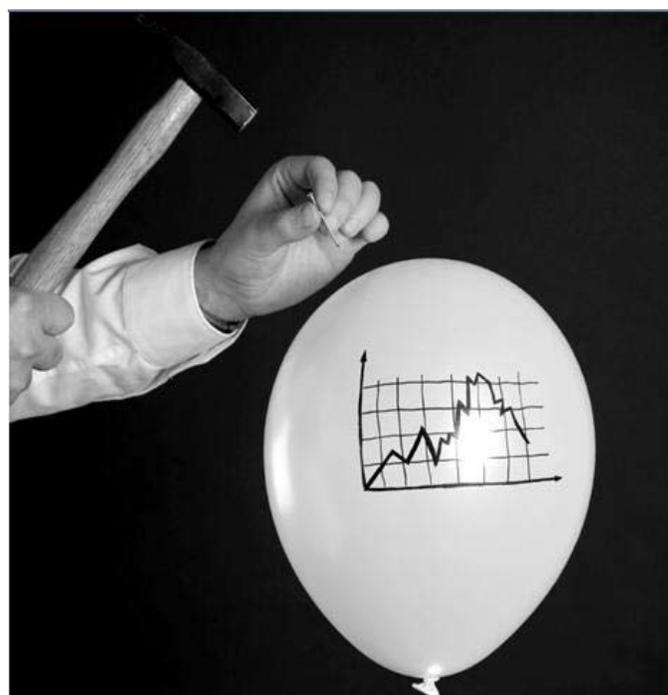
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“Timing the Sale...” continued from p.1

The ‘bubble’ phenomenon irregularly arises in the middle market, triggering sudden rapid growth in company valuations and M&A activity within an industry. A bubble may inflate dramatically but invariably, it is only a matter of time before the bubble collapses, causing significant market devaluation across the affected industry and confronting would-be company sellers with significantly reduced values for their firms and, often, less buyer interest.

Listening to the “buzz” or popular discussions about exceptional transaction values that are simultaneously generated by a significant portion of companies in a particular industry is one way to identify a potential bubble. Middle market businesses generating purchase multiples exceeding five times EBITDA – more specifically 8 to 12 times EBITDA – often indicate an emerging bubble.

Bubbles tend to last three to four years and purchase prices tend to peak three-quarters of the way through the bubble’s cycle. Buyers are willing to pay the highest investment values at that point because



“Timing the Sale...” continued from p.3

prospects of future industry growth are still evident. Bubbles eventually burst and middle market company valuations in the affected industry generally return to 5 times EBITDA multiples because the rapidly-rising transaction valuations of companies sold going into the peak of the bubble and the resulting “rich” purchase prices deplete the affected industry’s upside growth potential and the potential profitability of a transaction. Additionally, the bubble industry’s goods and services’ supply and demand eventually return to equilibrium.

Before the Information and Technology Age or dot.com era, a seller’s age constituted a major factor determining when to sell a business. A 55-year-old owner, considering retirement, would seize the opportunity to sell while the valuation cycle was peaking. On the other hand, a 25-year-old owner likely would decline to sell, preferring to remain active in the industry, growing and transforming the business in anticipation of a sale of the company during the next market cycle (or bubble). Yet, post 1990s bubbles are unlikely to appear again in the same manner and industry. Middle market business owners of every age who are fortunate enough to find themselves operating in an industry experiencing a bubble should consider taking advantage of their companies’ inflated valuations and sell while their companies’ purchase prices are between 8 and 12 times EBITDA multiples.

The government contracting industry currently is experiencing an industry bubble driven by dramatic increases in the industry’s M&A activity and significant government spending on defense and homeland security. The bubble originated following 9/11 and has persisted for an unusually long period of time, most likely due to the duration of the US’ ongoing involvement in the Afghanistan War and the Iraqi reconstruction. Over the past couple of years, the bubble has weakened as government defense contractor spending began to plateau. As a result, contractors are beefing up their cyber security capabilities through various IT acquisitions in

preparation for the next technology bubble. The passing of the new healthcare legislation also will cause healthcare services and healthcare technology to undergo significant growth that is expected to continue for the next several years.

It is only a matter of time before the defense (and later, healthcare) bubbles burst and opportunities to realize maximum values for companies operating in these industries pass. The key to surviving bubbles is being able to fully recognize and understand when it is best to sell. 20/20 hindsight can be extraordinarily expensive once the bubble has collapsed. Furthermore, an industry that has seen the collapse of one bubble will be highly unlikely to experience another bubble for a long period of time. ♦

Technology & Telecom

The \$7 billion American Recovery Act of 2009 (ARRA) Broadband Initiative investment program is poised to launch the largest investment in infrastructure since the competitive telecommunications and commercialization of the Internet millennial boom.

There are sustainable (and superior) return on investment opportunities for the private sector to support deployment of telecommunication networks and, once completed, to leverage broadband applications from these platforms.

To read more, [click here](#) or contact Steve Mooney at smooney@mcleanllc.com or 301.395.8612.

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About The McLean Group

The McLean Group is a national, middle market investment bank providing mergers & acquisitions (M&A), capital formation, market intelligence, business valuation, litigation support and exit planning services. The McLean Group serves businesses generating up to \$500 million in annual revenues. Headquartered in Northern Virginia's technology, communications and government contracting corridor, the firm is among the largest independent middle market investment banks in the Washington, DC area. The McLean Group is a FINRA Registered Broker/Dealer and Member FINRA/SIPC.

- **M&A:** The McLean Group uses its considerable expertise in a wide variety of industries to identify the most probable and suitable candidates to complete transactions under the most favorable terms for its clients.
- **Capital Formation:** The McLean Group arranges private equity, venture capital, senior debt and subordinated debt in amounts ranging from \$5 million to \$250 million to support clients' expansions, mergers & acquisitions (M&A), refinancings, recapitalizations, leveraged buyouts and shareholder liquidity objectives.
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- **Business Valuation:** As a core competency and complement to its M&A business, The McLean Group provides business valuation services, including intangible asset and financial security valuations for a variety of transactions, financial reporting and tax purposes.
- **Litigation Support:** From quantifying economic damages to valuing a minority interest in a business, the firm has the business valuation experience and credentials to support cases involving a variety of legal issues.
- **Exit Planning Services:** Based on its extensive experience advising owners of middle market businesses, The McLean Group has developed a proprietary process that analyzes more than 60 value/risk drivers that can have a significant impact on the value of a business.

