

Strategic Approaches for Selling or Transitioning a Business

How best to structure and profitably
expand a business to realize gain

– FEATURING –

David C. Gates

President and Managing Director – Gates and Company

James M. Higgins

Senior Vice President – Sun National Bank

David K. Plotts

Director of Financial Planning – Glenmede



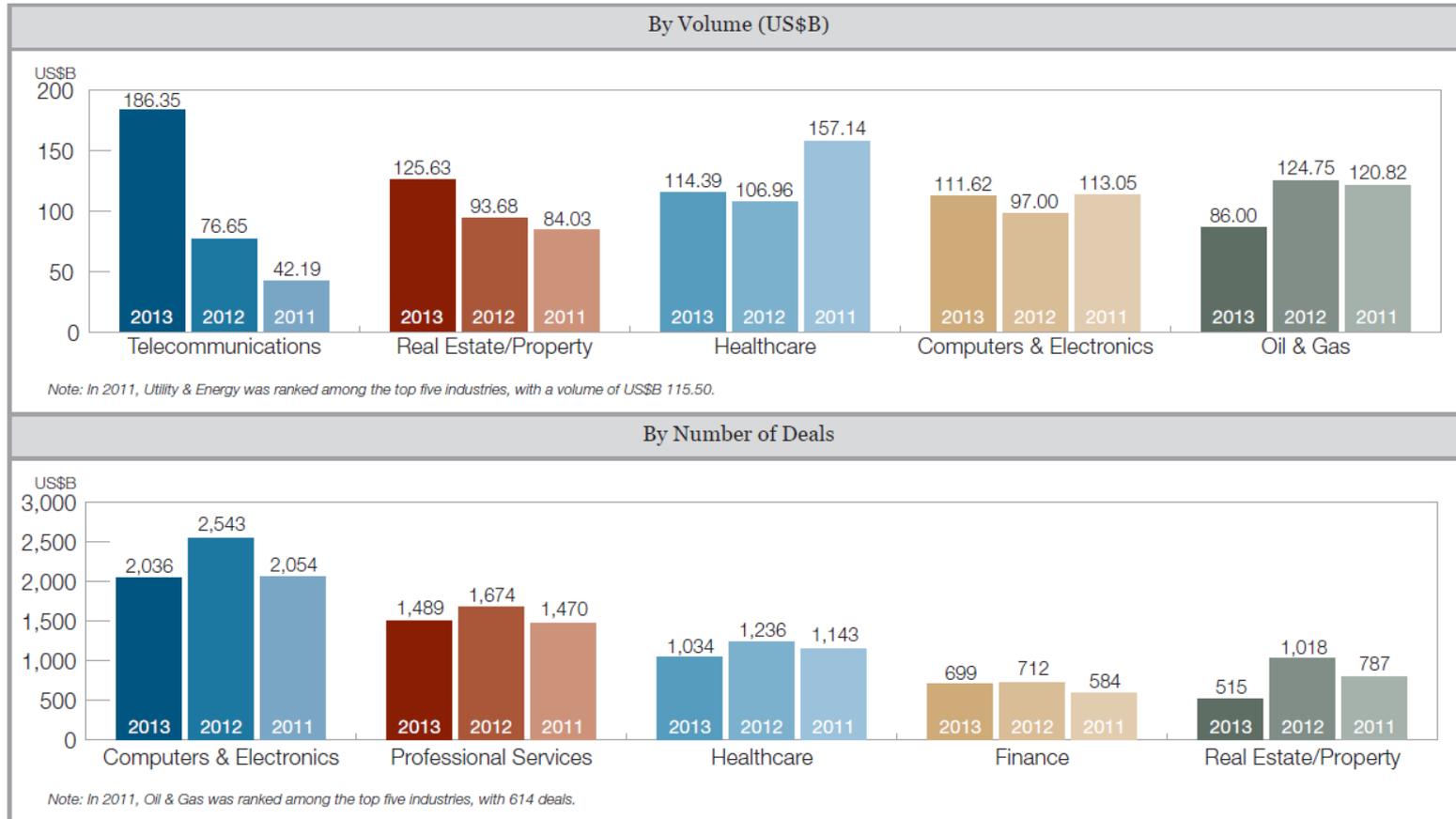
Strategic Approaches for Selling or Transitioning a Business

February 22, 2014

Outline

- **M&A Market Dynamics**
- Selling Considerations
- Preparing to Sell
- The Sales Process
- Legal Considerations
- Final Thoughts and Summary

U.S. M&A Activity



Source: Paul / Weiss

U.S. M&A Activity (Dec. 2013)

Publicly-Held Market

	Strategic	Financial	Total/Avg
Volume	\$58B	\$29B	\$87B
Number of Deals	611	146	757
Average Value	\$268M	\$521M	\$319M
Average Multiple	14.4x	11.8x	14.0x

Source: Paul / Weiss

M&A Activity

Privately-Held, Middle Market

	Q1	Q2	Q3
Average Multiple	5.9x	6.5x	6.6x

Year-to-date through Q3, aggregate total debt was 3.6x

Source: *GF Data Resources*

US Venture Capital Activity

- \$7.8B invested in 1,005 deals in 3Q 2013
 - Up 12% in dollars and 5% in number of deals from 2Q
- First three quarters of 2013 tracking slightly higher than 2012 both in dollars and deals
- 3Q 2013 sector leaders:

1. Software	\$3.6B	420 deals
2. Biotechnology	\$852M	123 deals
3. Medical Devices	\$566M	65 deals
4. Media & Entertainment	\$541M	100 deals
- “Cut-across” sectors declining:

▪ Internet-Specific	\$1.5B	252 deals
▪ Clean Technology	\$297M	40 deals



Source: PWC Money Tree

M&A Outlook

- Activity expected to remain solid in 2014, due to:
 - Cash on corporate balance sheets
 - More confidence in overall economy
 - Continued low interest rates
- Middle-market deals expected to dominate in 2014
 - 77% < \$250M
 - 12% > \$250M < \$499M
 - 5% > \$500M < \$999M
- Most active industries:
 - 44% Technology/Media/Telecommunications
 - 41% Healthcare/Pharma/Life Sciences
 - 28% Financial Services
 - 27% Energy
 - 21% Consumer
 - 18% Diversified Industrial



Source: KPMG

Outline

- M&A Market Dynamics
- **Selling Considerations**
- Preparing to Sell
- Sales Process
- Legal Considerations
- Final Thoughts and Summary

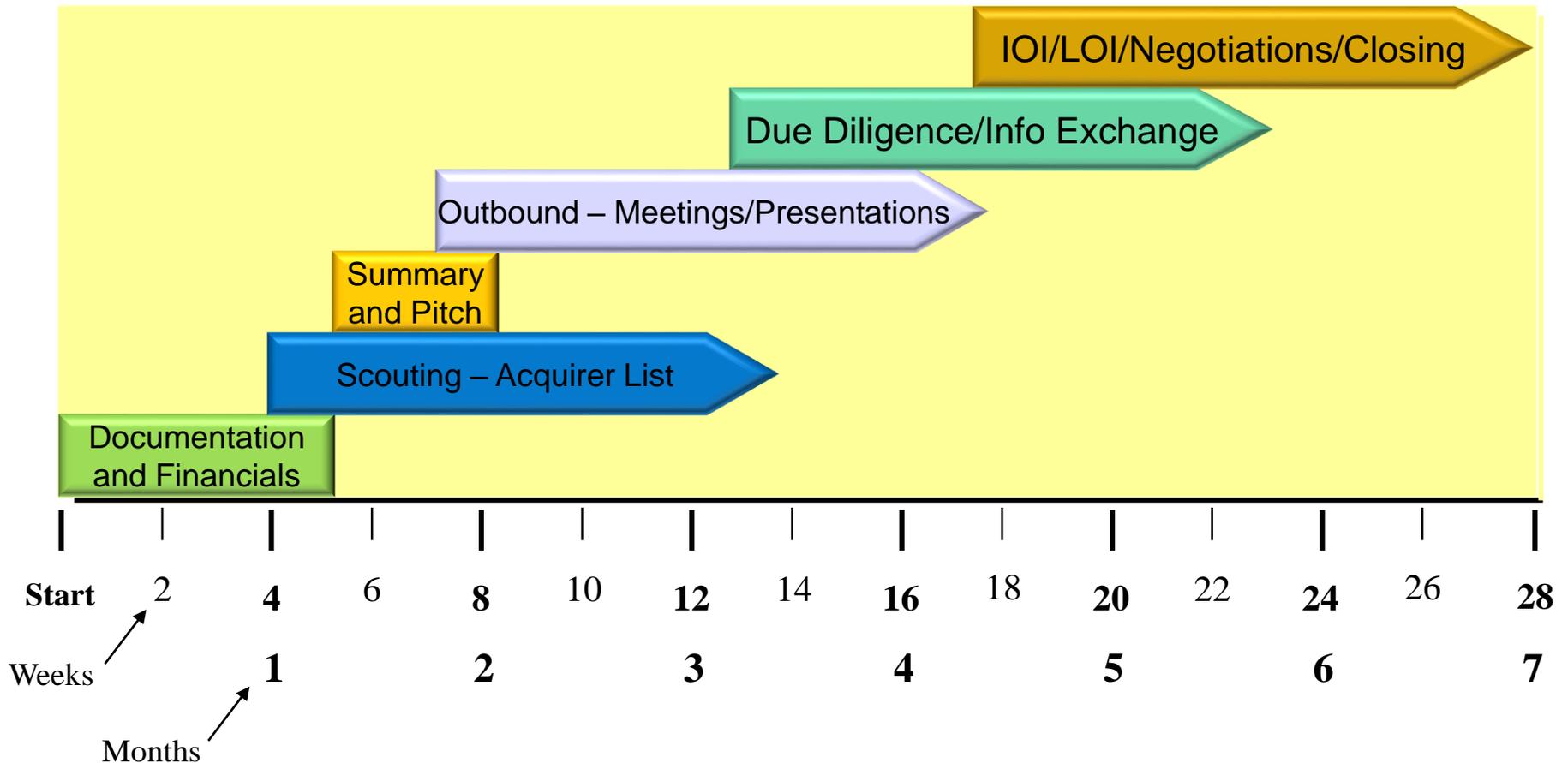
When is the Right Time to Sell?

- **Valuation**
 - Business performance and trajectory
 - Market trends and market value drivers
 - Financial markets
- **Infrastructure**
 - Physical assets
 - Operations
 - Sales and marketing
 - Legal issues
- **Management and Ownership**
- **Process takes time**
 - Build business for the sale
 - Understand key requirements



Sales Process Overview

Gates and Company Transaction Process Timeline



Who Needs to Know?

- **Confidentiality is key!**
 - Competitors will spin impact of the transaction
 - “Fringe” customers could use as excuse to switch
 - Partners could get nervous – loss of relationship or key contact(s)
 - Suppliers could change terms
- **Internal**
 - Senior financial resource
 - Other?
- **External**
 - Lawyer
 - Investment Banker
 - Personal Financial Advisor
 - Accountant
 - Other?



Outline

- M&A Market Dynamics
- Selling Considerations
- **Preparing to Sell**
- Sales Process
- Legal Considerations
- Final Thoughts and Summary

Documentation Overview

- Offering memorandum
- Financial compilation
- Target acquirers list
- Anonymous executive summary
- The “pitch”
- Non-disclosure agreement
- Form of Indication of Interest
- Form of Letter of Intent
- Due diligence binder (secure data site)



Financials and Recasting

- Privately held companies' financials are recast to reflect how they would look as a public entity
- Typical add-backs include:
 - Owners' salary in excess of market
 - Management perks in excess of market
 - One-time extraordinary expenses
 - Operational/accounting policies for foreign subsidiaries
 - Other
- Balance sheet
- Anonymous executive summaries show basic P&L

Outline

- M&A Market Dynamics
- Selling Considerations
- Preparing to Sell
- **The Sales Process**
- Legal Considerations
- Final Thoughts and Summary

Scouting

- Various sales methodologies
- Criteria development
 - Strategic and/or Financial
 - Size (revenue, number of employees, etc.)
 - Target market sectors
 - Geographic considerations
 - Product/service offering
 - Seek *fits* and/or *gaps*
- Methods for identification and tracking
 - Proprietary database
 - Internal professionals and contact network
 - Venture capital and private equity firms
 - Trade associations
 - Market research
 - Contact management system for tracking



Outbound Phase

- Blueprint target
- Anonymous contacting
- Peeling of the onion:
 - Phone pitch
 - Anonymous executive summary
 - Full offering memorandum
 - Meeting/conversations with management
 - Due diligence for IOI and/or LOI
 - Signed LOI triggers detailed due diligence
- “No Shop” periods
- Preemptive offers



Due Diligence Checklist

1. Business

- a. Business history – brief.
- b. Current business plan and budget.
- c. Copies of any documents (i.e., published studies, articles, etc.) supporting the marketing data and other statements in the business plan.
- d. Copy of any due diligence work done on/by the Company within the past 24 months.

2. Market Dynamics, Clients, and Competition

- a. Describe markets served
- b. Clients
 - i. Client reference list – representative list and contact information (names, telephone, and e-mail).
 - ii. List current clients, ranking by last fiscal year's revenue (including a list of top ten customers for each of the last three years by revenue available, indicate expected revenue for suppliers list. volume). Indicate buying units for those companies with multiple buying locations. Also, where current fiscal year for clients; as well as those for which you are on the preferred suppliers list.
 - iii. Describe representative client engagement/contract.
 - iv. Representative set of client contracts.
 - v. Samples of any client satisfaction surveys or reference letters.
 - vi. Describe client situations that are in trouble, if any.
- c. Competition
 - i. Provide list of key competitors and estimated market share.
 - ii. Describe how Company attempts to differentiate itself versus competition.

3. Products and Services

- a. Describe current offerings – include complete set of marketing and promotional materials and company newsletters.
- b. Price list with discounts.
- c. Describe price trends – by offering, historical, expected.
- d. Contract with rebates.

4. Sales and Marketing

- a. Describe how products and services are marketed and sold.
- b. Provide detail on current sales pipeline.
- c. Describe any formal business alliances (e.g., alliance partner, nature of relationship, purpose, results to date, etc.)
- d. Describe how contracts are bid and managed for each product/service offering.

Due Diligence Checklist

- a. Sales management:
 - i. Sales organization
 - ii. Territory description
 - iii. Compensation plans
 - iv. Sales cycle
 - v. Pricing policies
 - vi. Forecasting process
 - vii. Method of measuring and tracking key elements of the sales process
 - viii. Sales performance reports for the last 12 months
- b. Describe sales process to 1) gain new clients and 2) build existing relationships; list client assignments by salesperson.
- c. Provide samples of marketing literature.

5. People and Organization

- a. Organization structure.
- b. Profiles of key people and their specific duties.
- c. Compensation plan of key employees.
- d. Employee headcount over last three years and general comments about titles, salaries, and service date.
- e. Policies and benefits
- f. For 1099 independent contractors, copy of their contract and corporate ID number.
- g. Describe recruiting and retention system. Describe any unique methods, systems, incentives, etc. to recruit and retain staff and key personnel.
- h. Indicate relevant data for new hires, turnover, etc., for the past two years.

6. Financial Information

Historical

- a. Annual financial data since 1999 (audits, review, or detailed internal statements).
- b. Current year-to-date results (and comparable prior year results).
- c. Monthly and/or quarterly financial statements for past two years and year-to-date (for total Company, each line of products/service, and each location).
- d. Adjustments – identify any expenses that were unusual “one-time” charges in each year and/or would not be incurred following a transaction.

Projected

- e. Current version of the 2002 financial plan by month or quarter (as detailed as possible) and the 2003 plan (total year) with projected cash flow and balance sheet statements.
- f. Any longer term financial and/or business plan if available.

General Information

- g. Auditors – name, contact, phone number, and e-mail.
- h. Current management key element reports.
- i. Description of accounting policies in use (revenue recognition, etc.)
- j. Management letters from auditors and replies thereto.

Due Diligence Checklist

- k. Capital expenditures for the past two years and for current year broken down according to:
 - i. Amount spent on new versus replacement equipment.
 - ii. Amount of capital expenditures by significant item and as a percentage of total expenditures.
 - iii. Depreciation expense.
- l. Charges to operations over the past two years.
- m. Credit terms with suppliers/vendors
- n. Schedule of lease rental expense and estimated increase on any lease renewal.
- o. Description of banking relationships, including name, address, and phone number of major lending institutions, contact at each institution, length of relationship, size of current credit limits, and outstanding balances.
- p. Closing binders from each round of debt/equity financing, including terms and conditions.
- q. List of current shareholders and their ownership and capital structure.
- r. Description of any major liabilities or contingent liabilities that are outstanding.
- s. All documents and agreements evidencing borrowings, whether secured or unsecured, by the Company or its subsidiaries, including loan and credit agreements, promissory notes, and other evidence of indebtedness and all guarantees.

7. General Company Information

- a. Articles of Incorporation, by-laws and minutes of all shareholders, board, and board committee meetings.
- b. Shareholder Agreement and all amendments.
- c. Legal structure (C-corp, S-corp, LLC, etc.)
- d. Organizational chart by legal entity, division, and department.
- e. List of all cities and states where Company has offices.
- f. Copies of all existing or contemplated benefit plans, including any retirement and profit sharing plans and/or incentive stock option plans.
- g. Representative samples of all material employment agreements, non-compete contracts, and consulting agreements that are in effect or contemplated.
- h. All joint venture, research and development, marketing and distribution agreements to which the Company is a party.
- i. Description of all litigation in which the Company is involved.
- j. Types and amounts of all insurance policies.
- k. Identify legal advisors.

8. Government Regulation

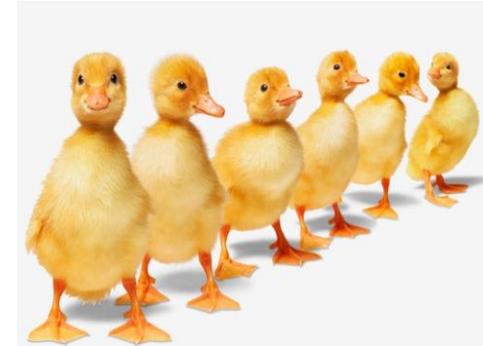
- a. List of all regulatory agencies and major legislation affecting the Company and its business (e.g., Federal, state, and local regulation). Copies of correspondence with these regulatory agencies.
- b. List of any trade or professional associations of which Company is a member.

Outline

- M&A Market Dynamics
- Selling Considerations
- Preparing to Sell
- The Sales Process
- **Legal Considerations**
- Final Thoughts and Summary

Operations and Governance

- Employment agreements and compensations plans
- Supplier and customer agreements
- Rental/lease agreements
- IP ownership
- Contract terms and assignment clauses
- Creditor terms and covenants
- Shareholder consents and approval requirements
- Board meetings, committees, and meeting minutes



Letter of Intent

- Starts with “Non-Binding”
- Form of transaction
- Purchase price
- Definitive agreement
- Access to company
- Representations and warranties
- Exclusivity (a.k.a. “No-Shop”)
- Conditions to closing
- Confidentiality
- Disclosure



Deal Structures

- Asset sale
 - Buyer preference: limits liability, favorable asset treatment
 - Seller will pay more in taxes and retains contingent liabilities
- Stock sale
 - Seller preference: transfers liability, capital gains
 - Buyer takes assets and liability, no favorable asset treatment
- Merger
 - Board approval, buyer takes liabilities, can involve stock swap
- Other
 - *“People can be creative!”*

Definitive Purchase Agreement

- Purchase and sale of ...
- Purchase price
 - Cash
 - Note
 - Stock
 - Earn-out
- Representations and Warranties
- Covenants (negative and affirmative)
- Conditions to Closing
- Indemnification
- General Provisions



Indemnification

- Settling post-closing issues and breaches
- Responsible party/parties
- Escrow and Holdbacks
 - May be tied to seller note
- Limitations (the “cap”)
- Claims (basket or deductible)
- Survival period



Outline

- M&A Market Dynamics
- Selling Considerations
- Preparing to Sell
- The Sales Process
- Legal Considerations
- **Final Thoughts and Summary**

M&A Drivers

- **Financial buyers:**
 - Buy, build or bolt, and flip
 - Pricing: ROI and EBITDA
 - Concerns: financial return and deal structure
 - Provide vehicle for secondary transaction
- **Strategic buyers:**
 - Fill product/service gaps, achieve vertical integration, diversify
 - Consolidation or buildup
 - Pricing: “accretive” and provide additional value through synergy
 - Concerns: integration, strategic fit, and culture – but may not want you!
- **Sellers:**
 - Achieve liquidity
 - Access additional growth resources
 - Sell into consolidation
 - Concerns: pricing, liquidity, and lifestyle

Transaction Success Factors

- Understand valuation approach and set reasonable expectations
- Multi-year history with minimal fluctuations
- Utilize performance metrics as appropriate
- Sales management and opportunity tracking
- Sellers' market or at least neutral
- Business performance tracking to projections during process
- At least two interested buyers
- Prepared for due diligence phase and responsive to information requests (especially financial)
- Expedient/successful execution
 - Negotiation, due diligence, and closing



Final Considerations

- Don't stop strategic growth planning
- Financial remuneration for key employees?
- Use pipeline approach – evergreen list of potential acquirers
- Work each opportunity like it is the only one
- Understand buyers' motives
- Don't snub a low offer – it can help the process
- Stock *versus* Asset sale considerations – ask accountant!
- Detailed letter of intent reduces legal wrangling
- Develop negotiating strategy early in process
- Clear ownership of Intellectual Property
- Clean capitalization table
- Consider *Reviewed* or *Audited* financials

Summary

- Be prepared!
- Key your eye on the ball
 - Continue strategic planning and implementing growth initiatives
 - Utilize business performance metrics and manage financial performance closely
- Monitor market and transaction activity
- Be reasonable about valuation expectation
- Make it easy to thoroughly document your business
- Build support team early
- Be prepared!



Contacts

Jason Adams

Associate, **Investment Banking**

(302) 428-1338 x10

JAdams@GatesAndCompany.com

David Gates

Managing Director

(302) 428-1338 x16

DGates@ GatesAndCompany.com

Kelly Gates

Principal

(302) 428-1338 x15

KGates@ GatesAndCompany.com

Debbie Hobbs

Associate, **Consulting Services**

(302) 428-1338 x10

DHobbs@ GatesAndCompany.com

What's Your
Attack Strategy?

GATES
AND COMPANY

www.gatesandcompany.com

The Role of Senior Financing in Leveraged Transactions

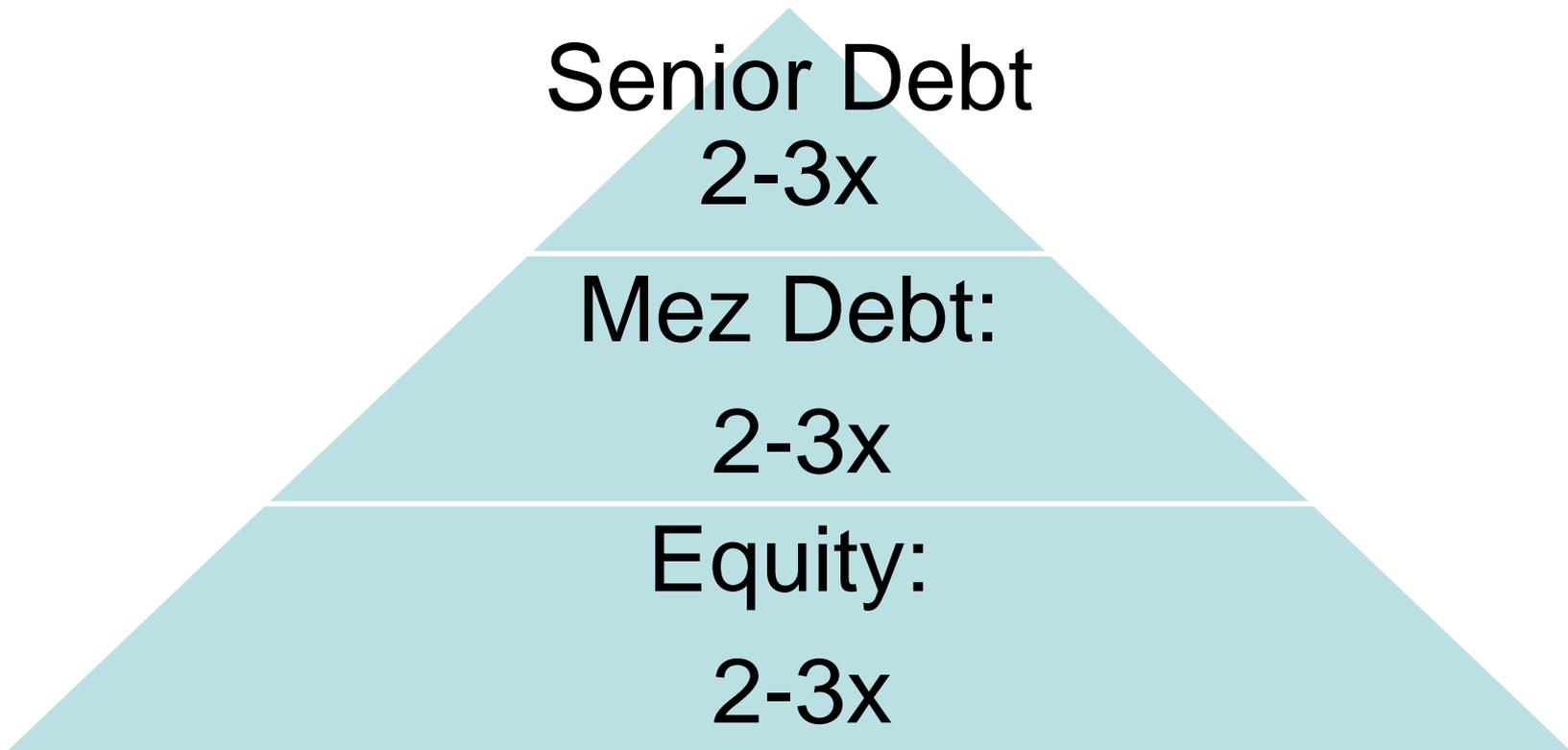


As a seller, why do you care?

- The availability of senior financing:
 - Makes your company more marketable
 - Makes your company more affordable
 - Makes the acquisition less expensive for Buyer
 - Allows Buyer to reserve some liquidity
 - The Buyer will have ongoing banking needs

The Capital Stack

Presumes 6x valuation



Typical Senior Terms

- Often unsecured or “collateral lite”
- Often unguaranteed (MBO vs. LBO)
- Terms and pricing reflect this:
 - Five year full amortization
 - Excess cash flow recapture
 - Restrictions on dividends & Cap X
 - Covenanted rolling 4q fixed charge coverage 1.20x

What Can Get Financing

- **Strong Management Team**
 - Well experienced in industry
 - Knowledgeable
 - Successful record
- **Sustainable Economic Fundamentals**
 - Important Customer Relationships
 - Viable Product or Service Lifecycle
 - Efficient Product or service delivery platform
 - Reasonably predictable cash flow

Case Study: Mgt. Service Co

- Owner and founder seeks to sell 50.5% of his share to his management team
- Company is 35 years old
- Fourth Largest Company in its segment
- Long term contracts
- High client retention
- Long-tenured management team
- Consistent EBITDA Growth



Structure

- Valuation of company was 5.1x TTM CF
- Bank financed 100% of buy-out
- New owners/managers personally guaranteed
- Payment reserve that burned off annually w. performance
- Collateral “lite” transaction
- Five year loan with graduated payments
- Excess Cash Flow recap; quarterly leverage and fixed charge coverage



Case Study: Product Distributor

- Owner looks to sell successful company
- Ten year history as reseller of branded security and business computer apps
- 75% concentration with one brand
- Diverse customer base (concentration:1%)
- High customer retention rate (90%)
- Low cost business platform
- Experienced new owners
- Multi-year history of EBITDA growth



Structure

- Valuation of company was 5x TTM CF
- Bank financed 1.5x CF; Seller Take-back held 1.5x CF and Equity contributed 2x CF.
- No Collateral
- No Guarantees
- Five year full amortization
- Distributions restricted to tax payments only
- ECF recap; quarterly leverage and fixed charge coverage



About Sun National Bank

- \$3.2 Billion in Assets
- 30+ year history
- Stable ownership (Brown Family/W.L. Ross & Co.)
- Strong capitalization (NASDAQ traded)
- Well-experienced senior commercial lenders
- Flat management structure
- Streamlined credit decision process
- Based in Mt. Laurel, NJ with PA Commercial Banking office



Wealth Planning for a Tax-Efficient Transfer of Business Ownership

David K. Plotts

Director of Financial Planning

The Glenmede Trust Company, N.A.

215-419-6686

david.plotts@glenmede.com

Basic Wealth Transfer Tax Rules

- ◆ **There are 3 US Wealth Transfer taxes**
 - Gift Tax on Lifetime Transfers
 - Estate tax on transfers at death
 - Generation-skipping transfer tax (“GST”) on transfers to grand-children or more remote descendants
- ◆ **Exclusions & Exemptions**
 - Annual exclusion \$14,000 per year per recipient
 - Exclusions for medical expenses and tuition
 - Lifetime exemption currently \$5,340,000 (\$10,680,000 for a married couple)

Wealth Transfer Tax Rules

American Taxpayer Relief Act (ATRA) of 2012

Signed into Law January 2, 2013

◆ The Basic Rules under ATRA

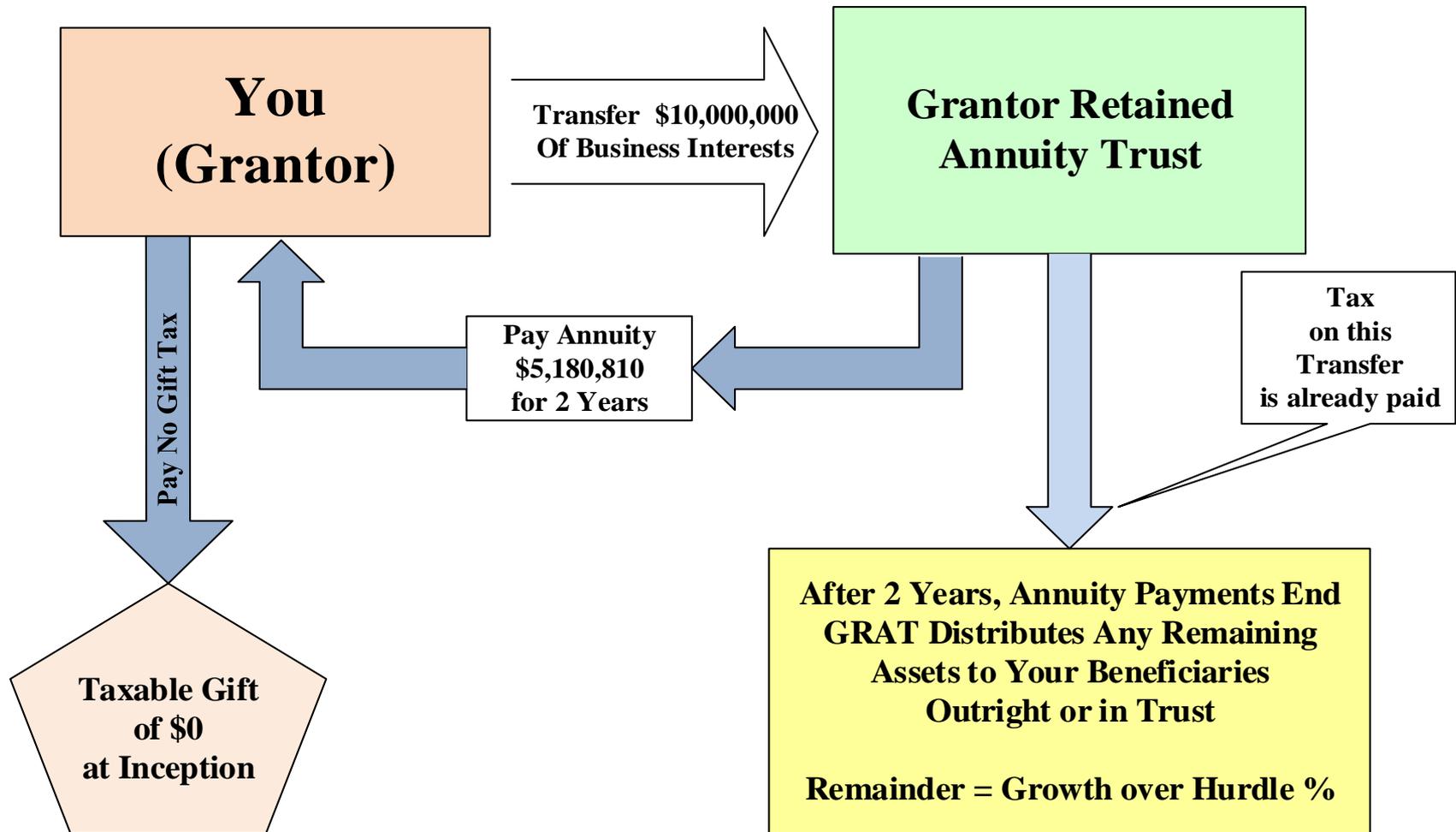
- Exemption set at \$5,000,000 per person but indexed for inflation. In 2014 that equals \$5,340,000 per person or \$10,680,000 for a married couple.
- Up to all of the exemption may be used during life with any balance remaining available to one's estate
- "Portability" of the exemption made permanent
 - Taxable estate of first spouse less than \$5,340,000
 - Survivor's exemption increased by the value of deceased spouse's unused exemption if certain conditions are met

◆ Tax rate is 40% (increase of 5%)

Planning Opportunities Under the New Rules

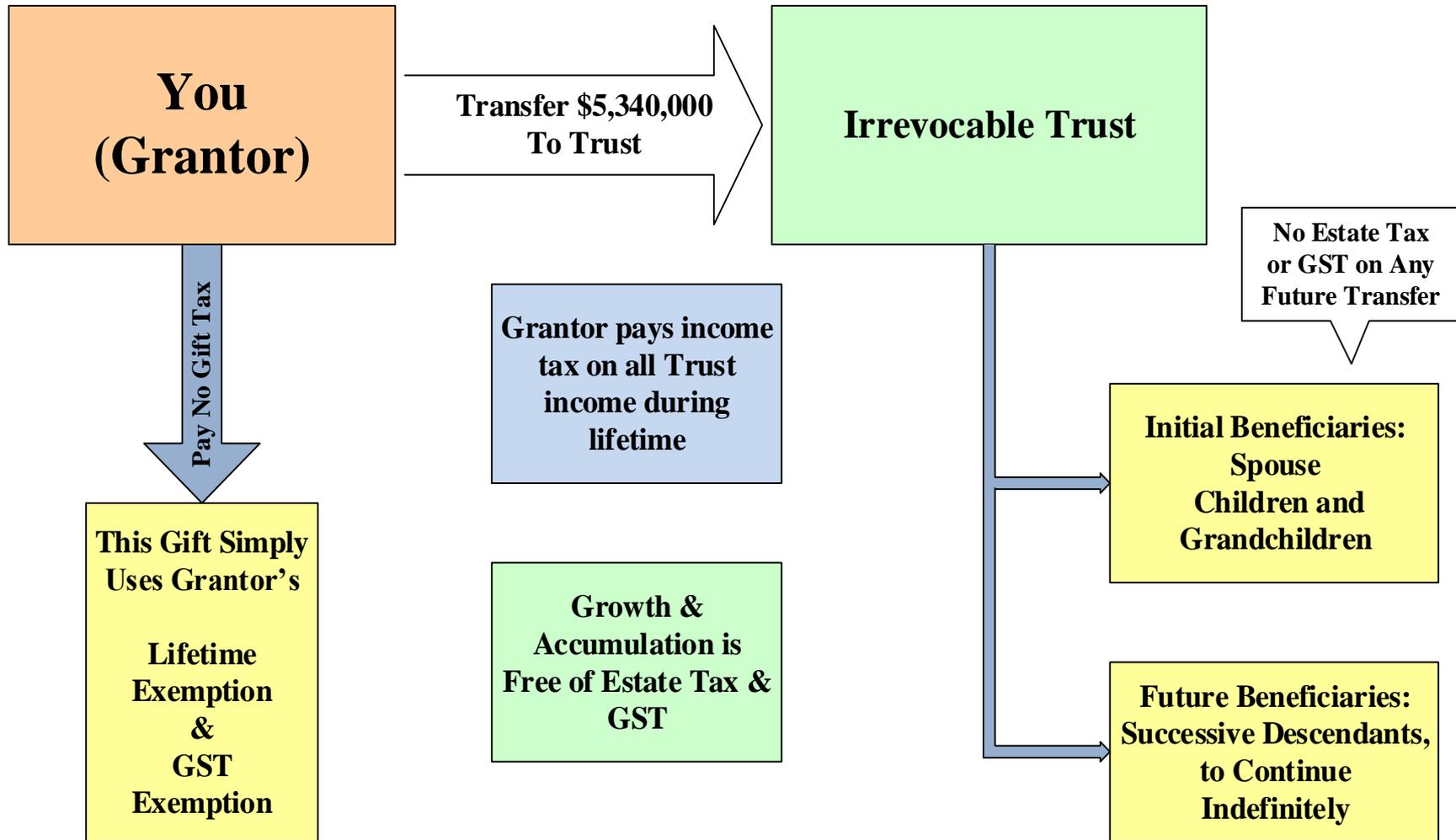
- ◆ **Alternatives for use of the \$5.34 million or \$10.68 million lifetime exemption**
 - Direct gifts to children/grandchildren
 - Gifts in trust
 - Intra-family Gift + Sale using favorable “AFR” rates
- ◆ **Sophisticated Planning Variations**
 - The Grantor Retained Annuity Trust
 - The “Intentionally Defective Grantor Trust”
 - The use of leverage – through sales, loans and valuation discounts

Grantor Retained Annuity Trusts (GRATs)

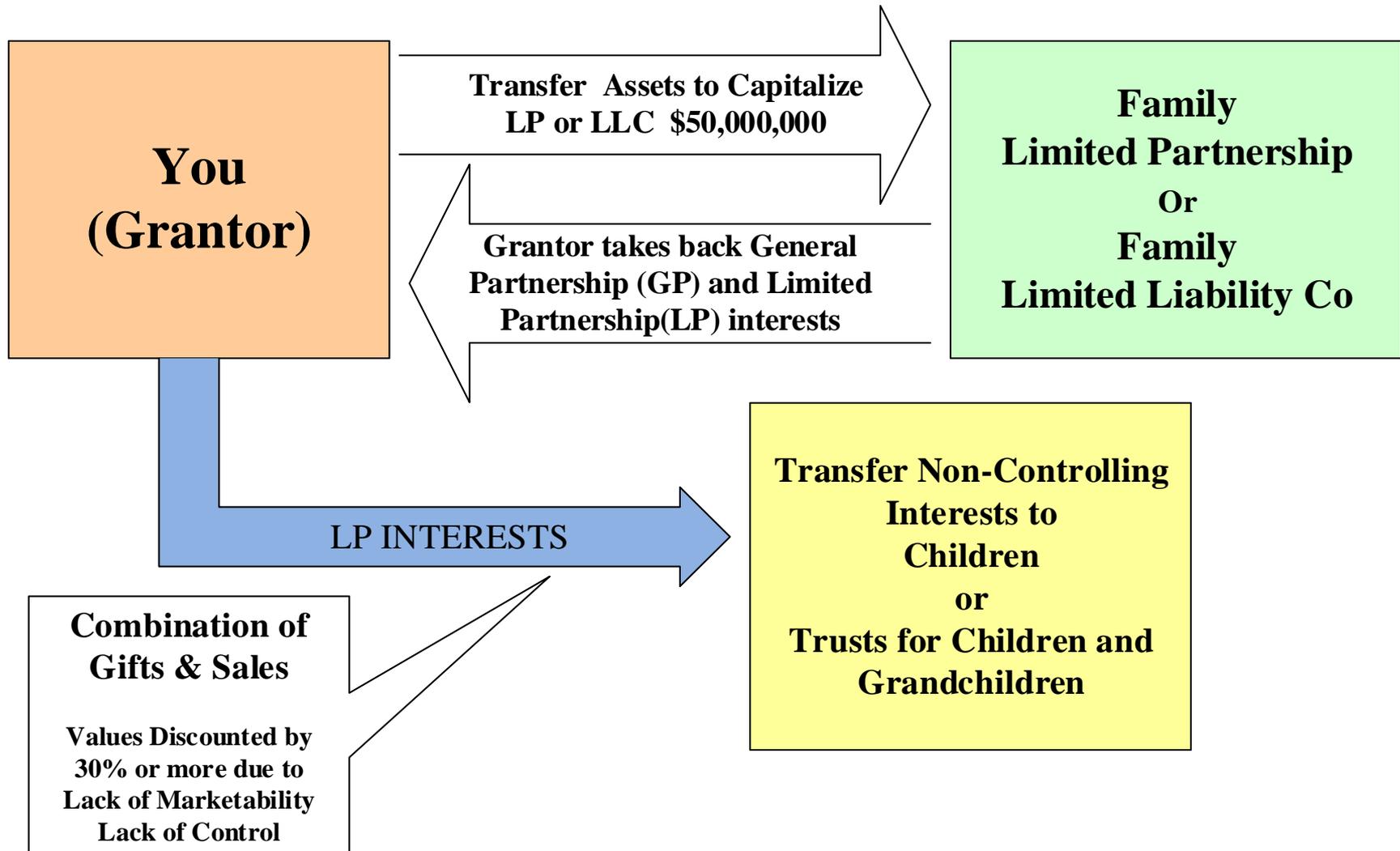


February 2014 = 2.4%

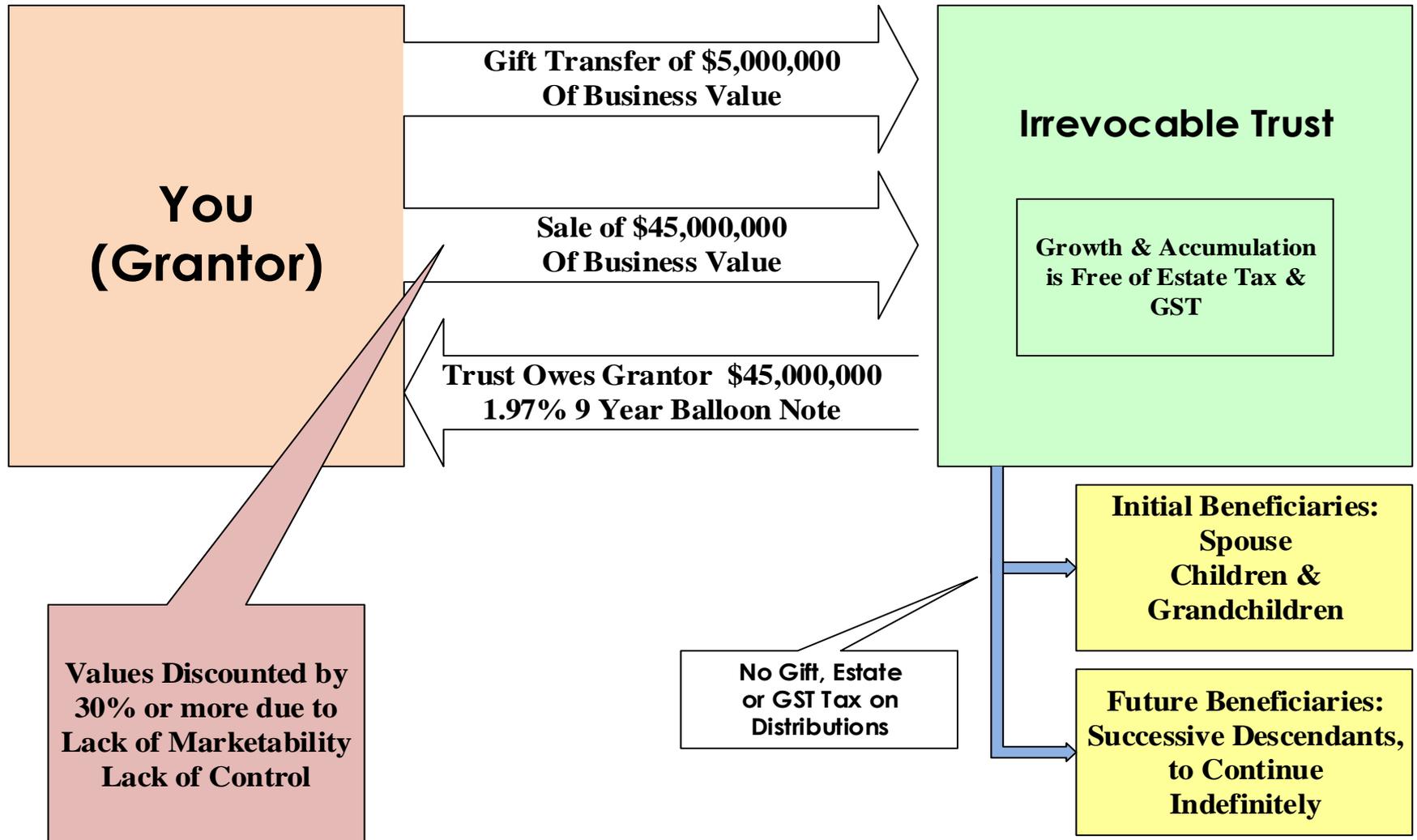
The Intentionally Defective Grantor Trust



The Use of Entities



Use of Leverage



What The New Tax Law Did Not Do

- ◆ **Does not prevent valuation discounts**
 - Lack of Marketability
 - Lack of Control
 - S-Corps, Partnerships, Limited Liability Companies
- ◆ **Does not add troubling provisions to GRATs**
 - Minimum length of 10 years was not implemented
 - Minimum taxable gift to beneficiaries not implemented
- ◆ **Does not disturb opportunity to leverage**
 - At historically favorable rates
 - February 2014 Section 7520 Rate is 2.4%
 - February 2014 AFRs - .3%, 1.97%, 3.56%

Summary & Conclusions

- ◆ ATRA made permanent the greatest opportunity for tax-wise wealth transfer since the modern estate tax regime was enacted in 1916
- ◆ Ability to make large wealth transfers – of particular importance to business owners
- ◆ Leverage further enhances the potential
- ◆ Don't wait until it's too late: Valuation Discount Vanishes when a deal is made – before the closing.