MERCER CAPITAL

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Private Initial Offerings

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An earlier edition of this article appeared in Chris Mercer's blog, MERCER ON VALUE, which can be found at www. merceronvalue.com. As a subscriber to VALUE MATTERS™, you may also wish to subscribe to MERCER ON VALUE. To do so, please visit www.merceronvalue.com and enter your email address in the "Subscribe" field in the upper right-hand corner of the blog.

In July of 2005, Fred Wilson wrote a post on his website, *A VC*,[1] on the subject of "back door IPOs." It was later referenced and augmented in another post on Tom O'Neill's website, *The Buyout Blog*[2]. Their posts provide a backdrop for introducing what may be a new name for another kind of initial offering, the *private initial offering (PIO)*.

An initial private offering (IPO) is an offering of private company stock to the investing public through the regulated, public securities markets. For reasons noted below, the IPO route to shareholder liquidity or growth capital is unavailable to most private companies.

A "back door IPO" is a transaction in which a private company merges into a publicly traded shell company in a process often called a "reverse merger." It is a reverse merger because the private company brings all the value but the shell company is the surviving entity. Shell companies typically have few, if any assets other than, perhaps, some cash. They may, however, have considerable liabilities, including poor reputations, sleazy owners (who make bad partners), no followings, and no real markets for their shares. The back door IPO tends to be used by companies that cannot or will not go through the usual process of an IPO.

For more information about the teleseminar series, see page 9 of this newsletter

1 http://avc.blogs.com/a_vc/2005/07/vc_cliche_of_th.html

2 http://www.buyoutblog.com/archives/2005/07/idle_shells_the.html

A private initial offering, or PIO, is an offering of private company stock, in whole or in part, to the private equity capital markets. The PIO is available to hundreds of thousands of companies that will never qualify for an IPO and who should not attempt a back door IPO. The concept of the PIO is certainly not new, but the terminology may be. Private equity groups have many billions of dollars, public market disciplines, experience in valuation and growing companies, generally excellent reputations, and few liabilities from the viewpoint of private company owners.

A Brief Review

A brief review of back door IPOs and private initial offerings follows:

Initial Public Offerings. What kind of market capitalization does it take to have a successful public company? There are virtually no front door IPOs with market capitalizations less than $100 million. The average market capitalization of successful IPOs is more in the range of $300 million or so.

If your private company is worth less than $100-$200 million, there is little reason to be thinking about the IPO market right now. Does that mean that there are no avenues for owner liquidity and/or growth capital? No, but back door IPOs are probably not the answer.

Back Door IPOs. Fred and Tom mentioned several reasons for private companies not to engage in reverse IPOs, including, as I interpret them:

1. *Liabilities*. Successor liability issues are usually unknown and perhaps unknowable.
2. *Valuation of the Public Shell*. Shell company owners demand "premiums" in mergers, which are difficult to value.
3. *Valuation of the private company*. There is no real valuation of the private company before the reverse merger and no competitive process to insure "fair" valuation.
4. *Valuation of the Combined Entity*. There are no road shows for back door IPOs to generate interest among institutional investors. What if we had an (back door) IPO and no one knew or cared? There is no way to estimate how the combined entity will trade after the back door IPO.
5. *Low prospects for liquidity*. Private business owners seeking liquidity will likely not obtain it with back door IPOs. Institutional investors tend to be prejudiced against this particular vehicle. With limited market potential after the transaction, the owner(s) may have stock in thinly-traded, little-followed public companies, and little access to liquidity.
6. *Future difficulties in raising capital*. Private equity investors are more likely to have an interest in investing in the private company before the back door IPO rather than after. If there is no real market, the back door IPO may diminish rather than enhance the ability to raise cash for growth.
7. *Costs of Being Public*. It has long been costly to be a public company, both in terms of management time and out-of-pocket expenses, to meet regulatory requirements. In the current environment, with Sarbanes-Oxley a reality, both costs are rising. Whether the costs of being public are $100 thousand or a million dollars or more, they are real and unavoidable, and a drain on valuation and market capitalization, particularly for smaller companies.

Private Initial Offerings (PIOs). The new "public markets" for smaller capitalization private companies are the private equity capital markets. There are literally hundreds of private equity groups (PEGs) which have each raised and are in the process of investing anywhere from $20 million to $50 million on the lower end, to many hundreds of millions of dollars or more for the larger groups.

Private equity groups have raised many billions of dollars for investment in private, corporate America. And they have lots of dry powder for future investments. These groups bring public market discipline and public market equity private corporate America.

In years past, the dream of many entrepreneurs was to engage in initial public offerings, or IPOs.

Today, given the breadth and scope of private equity capital markets, it is now possible to engage in another form of initial offering -- the private initial offering, or PIO. In a PIO, a company can be presented, in whole or in part, to the private equity capital markets.

While there can be exceptions, the entry point to the private equity capital markets tends to be in the range of $1.0 million in EBITDA on the very small side. This would imply a total capital valuation (equity plus debt) of $4-$6 million or so. As companies increase in size (as measured by sales, earnings and value), the interest levels (and pricing) tend to rise. PEGs, individually or collectively, can engage in transactions into the hundreds of millions or even billions of dollars ranges.

Advantages of PIOs

The advantages of PIOs include:

1. *Liabilities.* PEGs bring few, if any liabilities to the table when investing in private companies.

2. *Valuation.* PEGs are knowledgeable about valuation. Well-represented private business owners have their businesses presented to a variety of PEGs with appetites for similar investments. The valuation that develops from a competitive showing of the business is reasonably certain to provide a "fair" valuation for individual companies at the stage they find themselves. Of course, if a business is ready for sale, the chances improve that premium pricing will be obtained.

3. *Liquidity.* PEGs will structure transactions to purchase 100% of the equity of many businesses, providing total liquidity for their owners. Transactions can also be structured where private equity capital is invested to finance growth. Other transactions are structured such that owners sell large minority or controlling interests to PEGs, retaining significant interests and incentive to grow their businesses. Owners can thereby obtain current liquidity without jumping off the horse, so to speak, and have significant opportunities for the ongoing upside of their businesses.

4. *Flexibility.* Some of the flexibility provided by the PIO was seen in #3 above. The bottom line is that owners and PEGs can structure mutually agreeable transactions that can help owners achieve numerous objectives. For example, it is possible to structure transactions to provide liquidity for one or more shareholders while management retains ownership and growth prospects.

5. *Future access to capital.* Unlike the back door IPO, the PIO provides excellent access to capital following the transaction. The PEGs themselves can be the source of additional investment where significant growth prospects need to be financed. And the PEGs often have experience in taking companies public in the traditional way when they achieve the critical mass of sales, earnings and prospects.

6. *Regulatory costs avoided.* By remaining private, companies avoid both the time and expense of public company regulation.

The Bottom Line

It is well-known that PEGs are a significant source of capital and liquidity for private companies in America. Any time we take qualifying companies to market, we solicit interest from a number of private equity groups, as well as possible strategic buyers.

The point of this discussion of back door IPOs and PIOs is that business owners should consider the private equity capital markets as their primary source of liquidity and growth capital. Back door IPOs are a backwards and disadvantageous way to achieve liquidity. IPOs are not feasible for the great majority of even quite large private companies.

Companies often prepare for many years for their eventual IPOs. Private companies that lack the size to be public companies should also prepare themselves for their PIOs. That preparation can also take many months or even years. However, the PEGs are looking for many of the same characteristics in PIO investments that the markets are looking for in IPOs.

The message is clear: Now is the time for qualifying businesses to begin preparation for their private initial offerings, or PIOs. Once prepared, you don't have to execute, but once you are ready for sale, you can stay that way. And as we have previously noted you *will* sell your business. It is not a matter of if, but when. Is Your Business Ready for Sale?™

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A T T O R N E Y S

Mercer Capital Can Help You Help Your Clients

Mercer Capital has developed a presentation specifically for attorneys that you and your colleagues cannot afford to miss: *Buy-Sell Agreements, The Do's and Don'ts*. We explore the topic of buy-sell agreements from a business appraiser's perspective, highlighting those issues that typically get your clients into trouble.

In this presentation, you will gain insight into the folly of fixed-price or formula pricing, the different appraisal mechanisms, common misunderstandings that can end up big money issues, and, of course, we share insights into the pitfalls of buy-sell templates.

This presentation can help you help your clients and it's to the point - approximately 30 minutes in length (there is also an hour-long version if that better suits your needs). Depending upon schedules, delivery options are in-person or via webinar.

Contact Barbara Price at 901.685.2120 or priceb@mercercapital.com for a sample audio clip from our most recent presentation and to schedule a presentation to your firm today.

COMING SOON

Buy - Sell Agreements: The Do's and Don'ts

A New Book from Mercer Capital

Coming in the First Quarter of 2006

Mercer Capital has reviewed hundreds of buy-sell and other shareholder agreements, and we want to share our "lessons learned" with you. We do not offer legal opinions or guidance, but instead provide a list of things to watch out for and why they are important. Written for business owners, attorneys, CPAs, insurance providers, as well as other business appraisers, the book powerfully illustrates the valuation consequences of badly-drafted agreements.

To be notified of the publication date and qualify for the special pre-publication discount, email Barbara Price at priceb@mercercapital.com. Please type "Buy - Sell" in the subject line, and be sure to provide your name and address in the message.

ANNOUNCING MERCER CAPITAL'S E-BOOK LIBRARY

Title	Description	Investment	Release Date
Valuing Shareholder Cash Flows: Quantifying Marketability Discounts	*Quantifying Marketability Discounts* has been updated and is now offered as an e-book. Titled *Verifying Shareholder Cash Flows: Quantifying Marketability Discounts - 2005 E-Book,* this edition provides a brand new chapter which discusses each of the five assumptions of the QMDM in depth. As a bonus, when you purchase the e-book, you will also receive the *QMDM Companion,* the latest edition of the Quantitative Marketability Discount Model in spreadsheet format. We plan to continually add content to this e-book, and as a purchaser, you will receive this content free-of-charge when it becomes available.	**$95.00**	*Currently Available*
Valuing Financial Institutions	We are responding to requests to put this book back into print and we are doing so as an e-book	**$65.00**	*Currently Available*
Valuation for Impairment Testing	The first SFAS 142 valuation resource for CFOs and auditors. Also available in printed form at www.mercercapital.com	**$45.00**	*Currently Available*
Are S Corporations Worth More Than C Corporations?	An e-booklet that adds to the S Corp vs. C Corp. debate	**Complimentary**	*Currently Available*
Embedded Capital Gains	Mercer Capital's latest publication	**$19.95**	*Currently Available*

Visit our website at www.mercercapital.com for more information or to download an e-book.

MERCER CAPITAL ON THE ROAD

January 25, 2006
"Buy - Sell Agreements"
Firmwide Presentation: Glankler Brown Law Firm
Memphis, Tennessee
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March 9, 2006
"Marketing Your Business Valuation Practice"
Teleseminar sponsored by BV Resources
Barbara Walters Price, Moderator

May 2, 2006
Philadelphia Estate Planning Council Annual Seminar
Philadelphia, Pennsylvania
Z. Christopher Mercer, ASA, CFA

June 1
"Buy-Sell Agreements: Reasonable Resolution or Ticking Time-bomb"
NACVA's Annual Conference'
San Francisco, California
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The professionals of Mercer Capital have a great deal of experience speaking to industry and professional groups across the nation on topics such as:

- Buy-Sell Agreements
- The Integrated Theory of Business Valuation
- Is Your Business Ready for Sale?™
- Purchase Price Allocation
- Valuation of Employee Stock Options
- Litigation Support and Expert Testimony
- Valuation of Privately Held Businesses, Partnerships, or LLCs
- Financial Institution Valuation
- ESOP Valuation

To book a Mercer Capital professional as a speaker at your next conference or CLE/CPE meeting, please contact Barbara Walters Price at priceb@mercercapital.com.

A GENTLE PLUG FOR OUR FIRM

MERCER CAPITAL is a business valuation and investment banking firm serving a national and international clientele. Our reputation for excellence is based on an ability to solve complex financial problems expeditiously. We convert over 20 years of experience, including thousands of assignments, into solutions for the issues of today.

CORPORATE VALUATION. Mercer Capital provides a broad range of independent valuation and financial advisory services, including:

- Dispute Analysis Services and Expert Testimony
- Valuation for Corporate Tax Matters
- Valuation for Corporate Income Tax Issues
- Valuation for ESOPs
- Purchase Price Allocations
- Valuation of Employee Options
- Goodwill Impairment Testing
- Valuation of Intangible Assets
- Fairness Opinions

INVESTMENT BANKING. Mercer Capital's investment banking division and specializes in providing merger and acquisition services to sellers or buyers of private businesses or public companies divesting divisions and subsidiaries. In addition, we assist clients in industry consolidations, roll ups, and refinancings.

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Mercer Capital's
Complimentary Teleseminar Series

Is Your Business Ready for Sale?™

Presented by Z. Christopher Mercer, ASA, CFA

ONE SESSION REMAINING

January 18, 2006
Noon - 1:00pm (Central Standard Time)

If you missed either of the first two sessions (November 2 or December 14), you can purchase them on CD for only $49 each, or you can purchase the entire teleseminar series on CD for only $99. The CDs will be mailed to you shortly after each teleseminar.

REMINDER OF THE FINAL SESSION IN THIS TELESEMINAR SERIES

Session Three is scheduled for Wednesday, January 18 at noon - 1:00pm central time. In this session, we will reveal your "Pathways to Liquidity," or an overview of the markets for privately held businesses. We'll answer the questions:

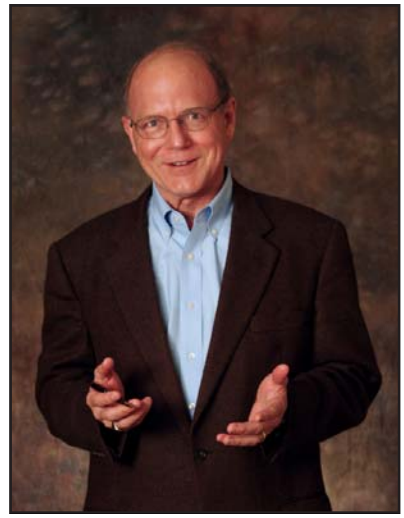
- What alternatives for liquidity exist for most businesses?
- Who are the buyers for businesses of various sizes?
- What are they looking for, particularly in the context of "Is Your Business Ready for Sale?"
- Why are private equity groups so important to you?
- Why do "multiples paid" tend to congregate in certain ranges for certain industries?

RECAP OF SESSION ONE: "A CALL TO ACTION"

Session One is a call to action. After listening to this session, business owners interested in selling their business now or in the future as well as their professional advisers will understand:

- Why the topic, Is Your Business Ready for Sale?™, is so important today
- Your business will sell, one way or another, and why you should plan for that transaction
- Your business is an investment and should be thought of as an investment, not a paycheck
- The dynamics of business value and growth
- The financial, operational and leadership characteristics of a business that is ready for sale

And, for those business owners who are buyers of businesses, we ask the question: "Is this business ready to buy?"



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A Personal Note from Chris

I have enjoyed looking at the world from the perspective of one who values businesses for many years now. That perspective has evolved into one causing me to examine much of what I see and hear based on implications related to value – and values – as both pertain to businesses, projects, strategies or whatever. Through this teleseminar series, I want to speak directly to the needs of business owners and their advisers. You can't work with business owners for over twenty years without learning a thing or two. I will be honored to share what I've learned with you.

Registration information on page 11 of this newsletter.

RECAP OF SESSION TWO: FOCUS ON "READY"

For those of you who missed this session, it was packed full of information that is actionable and applicable to running your business every day in a manner that increases its value to a potential buyer. The listener was treated to several "take-aways" or bits of information that no one else is telling you that you can use to enhance the value of your business. The session contained the following information:

Part I: Are You Ready for the Next Phase of Your Life?

- If you are 50 years old or older, we're talking to you
- The possibilities
- How to reach that next phase of your life

Part II: Leadership in the form of the acronym "M O S E S" ... or ...

- **(M)**anagement -- The responsibilities of effective managers and effective leaders
- **(O)**versight -- Why an active board is so important and the responsibilities of a good board
- **(S)**rategic Direction -- Why long strategic plans are a waste of time; how to develop and act upon a strategic plan that will enhance the value of your business
- **(E)**mployees -- How to best utilize your employees
- **(S)**tock Considerations -- Your business is not ready to sell unless the stock of your company is place where it needs to be placed in the event of a sale

Part III: Five things to focus on every day in the acronym "R E A D Y" ... or ...

- **(R)**isk -- The important risks you should be focused on in relation to your business as well as a hidden risk many people never think about
- **(E)**arnings or EBITDA -- a significant amount of time was devoted to the subject of earnings. EBITDA was defined; why EBITDA is so important and how buyers assess it; the pitfalls of "recasting" earnings; the ways buyers and appraisers develop values based on multiples of EBITDA; and two practical, but often, overlooked ideas that business owners can implement today to increase their earnings
- **(A)**bility, Attitude, Aptitude, and Activity -- The importance of having the right people in your organization and customer service measures
- **(D)**riving Growth -- 7 rules for growth: 1) sense of purpose; 2) understanding of the marketplace, 3) building an effective growth planning system, 4) customer-driven processes, 5) the power of technology, 6) attract and keep the best and the brightest, and 7) always look to the future. Specific examples of how a business owner can use each of the growth strategies to their advantage.
- **(Y)**ear-to-Year Comparisons -- Why looking at the financial performance of your company over a long period of time is important; what to look at and what private equity firms and other potential buyers look for.

Part IV: Putting It All Together

- The "Is Your Business Ready for Sale?™" Audit Worksheet

Questions answered in the session included:

- Who picked 65 as the mandatory "retirement" age anyhow?
- Why is succession planning so hard for so many business owners?
- How many businesses will transact in the next ten years or so?
- What risk is so important to focus on yet so often ignored?
- Why do private equity groups buy some businesses and not others?
- What one simple thing can you do today to increase your earnings and your margins?
- Why should the business owner be wary of "recasting" earnings?
- What do you do when an unexpected offer for your business arrives?
- What was the life-changing advice of Wally Lowenbaum and how can it make a difference in your business?
- How do you assess the strengths and weaknesses of your business today to enhance its value to an outside buyer?

Is Your Business Ready for Sale?™
Teleseminar Registration Information

Register Today for this **complimentary teleseminar series** and/or purchase the entire series on CD using our secure ordering system at **www.mercercapital.com/readyforsale.html**.

If you are unable to attend the teleseminars or wish to have the information available to you at any time, you can purchase the teleseminar series on CD for only $99. Shortly after each teleseminar, a CD will be mailed to you.

If you would like to send copies of this teleseminar series on CD to clients and/or friends, contact Barbara Walters Price at priceb@mercercapital.com for information on volume discounts.

You will receive a confirmation after your order. And, if attending the teleseminars, you will receive dial-in instructions several days before the scheduled teleseminar. Also, handout material will be e-mailed to you directly prior to the teleseminars.

SESSION THREE: JANUARY 18, 2006 -- "PATHWAYS TO LIQUIDITY"

Register today via the web at
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or by calling
Barbara Price or Matt Washburn at 901.685.2120