MERCER CAPITAL

BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

# Buy-Side Considerations

## For Middle-Market Companies Looking to Enter the Acquisition Market

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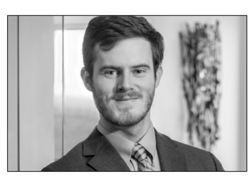

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BUY-SIDE CONSIDERATIONS

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## INTRODUCTION

Many observers predict that the market is rife for an unprecedented period of M&A activity, as the aging of the current generation of senior leadership and ownership pushes many middle-market companies to seek an outright sale or some other form of liquidity.

Obviously, not all companies are in this position. For those positioned for continued ownership, an acquisition strategy could be a key component of long-term growth.

For most middle-market companies, especially those that have not been acquisitive in the past, executing on a single acquisition (much less a broader acquisition strategy) can be fraught with risk. There are many elements, from finding the right targets, to pricing the deal correctly, to successfully integrating the acquired business that could derail efforts to build shareholder value through acquisition.

In this whitepaper, we cover buy-side topics from the perspective of middle-market companies looking to enter the acquisition market.

# IDENTIFYING ACQUISITION TARGETS AND ASSESSING STRATEGIC FIT

With aggregate M&A activity setting records in 2021 and continuing a strong pace in 2022, many businesses are exhibiting a thirst for growth or conversely their shareholders are eyeing an exit at favorable valuations.

With labor tightness, supply chain disruptions for capital goods, and financing costs fluctuating in real time, buyers and sellers are increasingly strategic in their mindset. Inflation and interest rates represent potential headwinds, but pent-up demand and plentiful war chests are likely to fuel elevated M&A activity in the foreseeable future. More than a few baby boomers have held on to their business assets making ownership succession and liquidity significant concerns.

Additionally, many middle market business assets are churned by financial investors with defined holding periods. Large corporate players and private equity buy-out groups generally have their own corporate development teams. However, small and mid-market companies, occupied with day-to-day operations, often find themselves with limited bandwidth and a lack of financial advisory resource to identify, vet, and develop a well-crafted strategic M&A rationale and then execute it.

This section provides touch points and practicalities for identifying viable merger and acquisition targets and assessing strategic fit.

## Motivation and Objectives

A rejuvenated appreciation for optimal capital structures and fine-tuned operations has largely debunked the oversimplified notion that bigger is always better. However, right-sizing is about achieving a proper, often larger scale at the proper time for a supportable price. A classic question in strategizing to achieve the right size is that of "buy" versus "build."

Many acquisitions are as much about securing scarce or unavailable hard assets and labor resources as they are about expanding one's market space.

Whether your investment mandate is to alleviate scarcities or to achieve vertical or horizontal diversification and expansion, tuning your investment criterion and financial tolerance to motivations and objectives is key.

These collective questions, among others, help address the who and the what of recognizing potential targets and assessing the pricing and structural feasibility of a business combination in whatever form that may take (outright purchase or merger in some form).

Given our experiences from years of advising clients, we have learned that the most obvious or simple solution is generally best. Many buyers already know the preferable target candidates but lack the ability to assess and the capacity to engage those targets. Additionally, many well-capitalized buyers lack the financial discipline to score, rank, and sequence their target opportunities with the expertise employed by large, active corporate developers and private equity investors.

> *Many buyers already know the preferable target candidates but lack the ability to assess and the capacity to engage those targets*

Understanding the magnitude and timing of the returns resulting from your investment options is critical. Constructing financial models to study the options of now-versus-later and the interactive nature of deal pricing, terms, and financing is vital to the process. These technical and practical needs must be addressed competently to grant buyers the freedom of mind and energy to critically assess deal intangibles that often influence the overall decision to move forward with a target or not. Cultural fit, command and control for successful integration, brand and product synergies, and many other factors ultimately manifest in an investment's total return on investment.

Scoring opportunities by way of traditional corporate finance disciplines using NPV and IRR modeling as well as using various frameworks such as SWOT Analysis or Porter's Five Forces is highly recommended. However, blind ambition and soulless math may not result in the best choice of targets.

One common sense and often overlooked assessment is how a seller's motivations may have a bearing on the risk assessment of the buyer. A seller today may be alerting today's buyer about future realities the buyer may experience. In some cases, sellers are motivated by a deficit of ownership and management succession. In other cases, a seller's motive may be the result of industry dynamics and disruption that may one day be the concern of today's consolidators. Get informed, get objective and be rational when assessing a target. If you cannot do that with in-house resources, get help. If you have in-house resources, have your mandates reviewed and your target analysis checked by an experienced advisor with the right balance of valuation and transaction awareness.

*Get informed, get objective and be rational when assessing a target*

## Take a Walk in the Seller's Shoes

We know that sellers often fear opening-up their financials and operations to certain logical strategic buyers. This may stem from generations of fierce competition or from a concern that not selling means the seller has revealed sensitive information that will compromise their competitive position or devalue the business in a future deal. Many sellers are extremely sensitive to retaining their staff and keeping faith with suppliers and customers. Buyers should understand that sellers require comfort and assurance regarding confidentiality.

Being proactive with non-disclosure agreements and even better using a third party such as Mercer Capital to establish contact may facilitate a process of mutual assessment that is initially a no-go for many tentative sellers. Buyers that demonstrate empathy for the seller's position and who employ a well-conceived process to initiate exchange are more likely to gain access to essential information.

It is common for the seller's initial market outreach to set the hurdle price for the winning buyer. That may occur as a result of the seller having reasonably skilled advisors who help establish deal expectations or through first-round indications of interest. As such, it should be no surprise for truly strategic buyers to be able to hurdle the offers of first round financial buyers or less optimal fringe buyers.

Buyers should also be aware that third party deals must win against the seller's potential ability to execute a leveraged buy-out with family members or senior managers, which may facilitate favorable tax outcomes versus the asset-based structures in open-market M&A processes. Of course, strategic buyers should be equally aware that many private equity or family-office buyers may also be strategic in their motivations and pricing capabilities based on pre existing portfolio holdings.

*Awareness of competing concerns for the target must be considered if you intend to win the deal*

Awareness of competing concerns for the target must be considered if you intend to win the deal. Buyers, with the help of skilled advisors, can actually help sellers address the balance of considerations that underpin a decision to sell. Having plans for human resource, communicating employee benefits and compensation structures, and laying the groundwork for a smooth integration process are part of walking the talk of a successful acquisition.

## Concluding Thoughts

Whether your motivations are based on synergies, efficiencies, or simply on the inertial forces of consolidation that cycle through many industries, a well-organized and disciplined process is paramount to examining and approaching the market for hopeful growth opportunities.

Regardless of your past experiences and deal acumen, we recommend retaining a transaction advisory team familiar with your industry and possessing the valuation expertise to maximize transaction opportunities and communicate the merits your firm has to offer the target and all its stakeholders.

# HOW TO APPROACH A TARGET AND PERFORM INITIAL DUE DILIGENCE

Business is good for many middle market operators and investment capital is generally plentiful. Are you an investor whose capital is industry agnostic, or does your capital need to be targeted at add-on investments that build on a pre existing business platform?

All business investors are "financial" investors – the real question is how "strategic" is their ability to leverage the assets of the target. Providing practical guidance on approaching a business target and conducting initial due diligence depends on the investor's criterion, competencies, and execution bandwidth.

In this section we assume you have identified a target or group of targets and you are attempting to learn enough about the target to determine whether to proceed with developing a meaningful indication of interest. Of course, an active seller is likely prepared for the sale process and represented by an advisor who is postured to provide the financial and operating information necessary for investors to quickly determine the suitability of a deal (i.e., a pitchbook and defined protocols for communication and information access).

However, many desirable targets may not be seeking a sale because business conditions are favorable, and their businesses have been managed to provide options to the owners regarding continued independence and turn-key ownership and management succession. If the former, you, as a prospective buyer may have already pinged on the radar of the seller, and if the later, you have mined for target opportunities and are ready for the next step to accomplish an acquisition. Our focus here is to summarize some practical considerations for approaching and vetting an identified target.

## First Contact

M&A is not easy. For every transaction that is announced a very long list of items for both the buyer and seller were satisfactorily addressed before two parties entered into a merger or purchase agreement. For the acquirers, first impressions matter a lot. There are no second chances to make a good first impression.

How a target is contacted can be pivotal to achieving receptivity and obtaining a critical mass of information. In cases where market familiarity or professional collegiality already exist, it can make sense for an investor's senior leadership to make direct contact with the target's senior management and/or owners.

*How a target is contacted can be pivotal to achieving receptivity and obtaining a critical mass of information*

In cases where the target is not familiar to the investor, then following a respectful and empathic set of protocols is key. Investors using professional advisors and/or who involve their senior decision makers are likely to be taken seriously by the target. Peer-to-peer contacts too far down the chain of command are more likely to be dismissed.

Owners and senior managers are keen to prevent the rumor mill from derailing business momentum and disturbing internal calm. A mindful and considerate process of first contact and initial discussions that is highly sensitive to the discrete nature of exploratory discussions will increase the probability that initial discussions and diligence can proceed to the next phase as a relationship based on trust develops.

In our experience, contacting a target through a financial advisor has an important signal function that the potential acquirer is serious and has initiated a process to prioritize and vet targets. Diligence procedures will be thorough and well organized; deal consideration and terms will be professionally scrutinized. Alternatively, some business owners and investors who initiate a process may be perceived as canvassing to see what sticks to the proverbial wall. This can inadvertently serve to inflate seller requirements and expectations assuming the initial inquiry is successful.

## Initial Due Diligence

Once the initial contact is established, it is important to follow-up immediately with an actionable agenda. Actions and processes include:

- Non-disclosure agreement
- Information request list
- Clear set of communication protocols involving specified individuals
- A centrally controlled and managed information gateway
- Establishment time frames and target dates for investigative due diligence, IOI, LOI, pre-closing due diligence, deal documentation, and ultimately closing

Organization begets pace and that pace culminates in a go or no-go decision.

## Preliminary Valuation

Procedurally, our buy-side clients typically request that we perform a valuation of the target using a variety of considerations including the standalone value of the target and potentially the value of the target inclusive of expected synergies and efficiencies.

A properly administered valuation process facilitates an understanding of the target's business model, its tangible attributes, its intangible value, its operating capacity, its competitive and industry correlations, and many other considerations that investors use not only for the assessment of target feasibility but as an inward-looking exercise to assess the pre-existing business platform.

*Our buy-side clients typically request that we perform a valuation of the target*

For first-time buy-side clients, our services may also include building leverageable templates and processes for future M&A projects. Additionally, our processes may be critical to the buyer's Board consents, the buyer's financing arrangements, and other managerial and operating arrangements required to promote target integration.

## Concluding Thoughts

Conducting target searches, establishing contact, and performing initial due diligence are critical aspects of successful buy-side outcomes. In general, there are as many (if not more) consequential considerations for buyers as there are for sellers.

Some buyers covet the conquest and go it alone without buy-side advisory representation. Conversely, even seasoned investors can benefit from third-party buy-side processes. Unseasoned acquirers may find their first forays into the M&A buy-side world untenable without proper guidance and bench strength.

As providers of litigation support services, we have seen deals that have gone terribly wrong as if predestined by inadequate buy-side investigation.

NEWSLETTER

# Middle Market Transaction Update

This newsletter analyzes deal volume, deal value, and other M&A indicators in the middle market in light of the current environment.

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# STRATEGIC PREMIUMS - CAN 2+2=5?

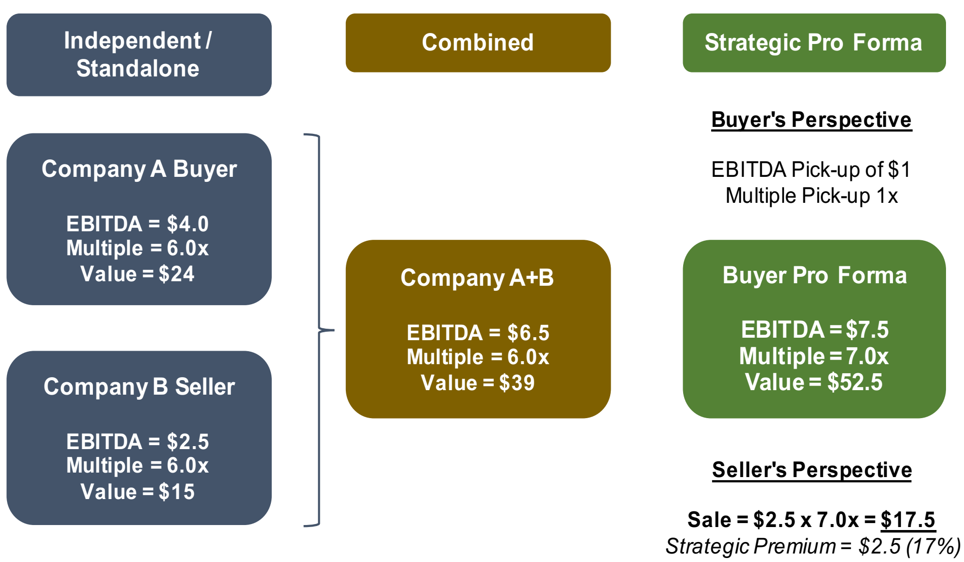
When given the choice between paying more or less for a good or service, it only makes sense that people prefer to pay less. Following this, a rational person would be expected to pay no more than the minimum available price for an item. Many modern business acquisitions appear to defy this logic – at least at first glance. According to Bloomberg, acquirers paid an average premium of 25.86% when making transactions in 2021. In other words, the average acquirer was willing to pay almost 26% above the intrinsic market value of a target business to successfully bid on an acquisition.

Theory holds that the value of any corporation, especially a controlling interest in such corporation, should have a value equal to the present value of the cash flows expected to benefit shareholders. This is called a financial control value and represents the intrinsic value of the company on a stand-alone basis. As evidenced by the premium data noted above, many acquirers buy businesses at a value higher than this intrinsic value, paying what is referred to as a strategic premium.

## What Is a Strategic Premium?

A strategic premium exists when a buyer expects that two plus two equals five, or possibly even some figure above five. In less abstract terms, acquirers pay a strategic premium when they expect that the combination of their business with another will generate more cash flow than both businesses on a standalone basis. A strategic premium reflects the portion of this added benefit that the buyer is willing pay to the seller to secure a deal.

For illustration, Company A (Buyer) and Company B (Seller) generate $4 and $2.5, respectively, of annual EBITDA. Prior to combining, the companies have an aggregate value of $39 (6x EBITDA). When Company A acquires B, it might pay 7.0x EBITDA ($17.50) because it expects the combined Company could generate $1 of added EBITDA through margin and/or growth for a total combined EBITDA of $7.5 of annually ($4 + $2.5 + $1) = $7.5) – providing for a combined value of $52.50 (7.0x EBITDA). The difference between Company B's stand-alone value of $15 and the $17.5 that Company A is willing to pay for it is $2.5, a 17% strategic premium. Company A spends $17.5 to increase its value from $24 to $52.5 – a deal that is accretive by $11.



## What Justifies a Strategic Premium?

The framework we provided for the strategic premium begs a larger question: what justifies a strategic premium? Ultimately, there are several possible explanations. Acquirers pay a strategic premium when they expect to gain some sort of efficiency through a business combination. As outlined in our previous example, they expect that these efficiencies will generate more cash flows than both companies can produce on a standalone basis. There are many efficiencies that companies could expect from a transaction, but three are most common.

*Acquirers pay a strategic premium when they expect to gain some sort of efficiency through a business combination*

### Cost Savings

Cost savings are the most common justification for strategic premiums, often because they are comparatively easy to forecast.

Let's go back to our two companies from earlier. Let's say that Companies A and B both need to purchase the same raw material to create widgets. Once the companies combine, they still need the same amount of raw materials, but they will likely place a smaller number of larger orders. Since each order that comes in will now be larger, their suppliers may give them a bulk discount, which lowers the overall cost. By combining, Companies A and B are spending less money to bring in the same amount of revenue-generating raw materials, leading to larger amounts of profit and free cash flow.

Cost savings can come from supply costs, staff eliminations, or any number of other areas. These savings are usually both the most obvious and quickly achieved strategic enhancements following an acquisition.

### Revenue Enhancements

Revenue enhancements are another common justification for strategic premiums but are harder to model.

There are many ways in which revenue enhancements can occur, but we focus on a simple example for the sake of this article. If Company A has a large distribution network, they can use that network to sell Company B's products to a larger group of people than Company B had been able to previously. Bringing in this additional should increase profits and create more free cash flow.

### Process Improvements

Process improvements come about when the companies involved in a transaction absorb each other's core competencies or assets. Mixing these competencies or assets can create revenue enhancements and/or operational efficiencies.

Continuing our examination of Companies A and B, Company A might pay a premium for Company B if they see that Company B has some sort of proprietary efficient process for creating widgets that

Company A could learn and take advantage of. In today's world, such considerations often focus on technology – be it software of some other form of technology. If the target company's technology can be utilized by an acquirer to enhance the acquirer's own cash flow, a strategic premium may be in the offing.

## Should You Pay a Strategic Premium?

Now that we have reviewed the theory behind strategic premiums, we discuss how they can be advantageous or detrimental to acquirers.

Perhaps the most obvious benefit of paying a strategic premium is that it can prevent other firms from purchasing the acquiree first. Sellers in a transaction are incentivized to maximize price. By paying a higher premium, strategic acquirers can entice sellers away from financial buyers or other seemingly "less strategic" buyers. On the other hand, paying a strategic premium is a potential risk. A higher acquisition price increases the amount of cash flows necessary to recoup the acquirer's investment. If the premium is too high, even an acquisition with compelling strategic benefits can become unprofitable.

*The reasonable price to pay for a target depends on the buyer. Different suitors will expect different efficiencies from the acquisition*

Ultimately the reasonable price to pay for a target depends on the buyer. Different suitors will expect different efficiencies from the acquisition. To avoid paying too large of a premium, acquirers must have a realistic notion of what they can pay for a target before entering negotiations. Even then, buyers need to exercise discipline and know when to walk away from a bidding war that has gotten too heated.

Acquirers are most likely to be successful when they have an organized process for ensuring that the rationale behind the acquisition justifies the transaction price. Such a process usually includes the analysis (and scrutiny) of the specific enhancements anticipated from a transaction. Strategic enhancements often seem reasonable when considered generally but may fall apart (or at least shrink in magnitude) when under the light of detailed financial inspection. Premiums paid on the basis of only a general consideration of strategic enhancements could be doomed for failure. The success of such deals is often based more on luck than anything else.

## Concluding Thoughts

To mitigate the risk of overpaying for an acquisition (and to reduce the impact of pure luck), we recommend a detailed financial inspection of both the target company and the potential strategic value of any transaction. As part of this analysis, it will likely benefit an acquirer to retain a transaction advisory team that possesses financial and valuation expertise.


TRANSACTION
UPDATE

# CONSIDERATIONS IN MERGER TRANSACTIONS

When considering a buy-side transaction to expand, many middle market companies may not consider a merger transaction as an option compared to an outright acquisition. Mergers are often seen as transactions for big conglomerate-type companies on Wall Street, but they can be effective for middle-market businesses as well.

A merger is a combination of two companies on generally equal terms in which the transaction is structured as a share exchange although sometimes a modest amount of cash may be included, too. There are many questions that must be addressed. The key economic question involves the exchange ratio to establish the ownership percentages based upon the value of each company and the relative contribution of sales, EBITDA and other measures to the combined company.

Corporate governance and social issues are important factors to consider also. Because the "target" shareholders are not cashed out, a significant amount of time, early in the process, should be spent exploring the compatibility of directors, executive management and shareholders.

## Why a Merger?

A basic premise from a shareholder perspective is that a merger will increase value through enhanced profitability, growth prospects and perhaps from the perspective of an acquirer of the combined company.

Stated differently, both shareholders should own shares in a company that will be more valuable than the interest in each independent company.

Assuming the parties are comfortable with governance and social issues, a merger can be an excellent means to grow the business when one of two conditions exist:

1. Neither ownership group wants to truly exit; and/or
2. Neither company has enough capital to fund a buy-out acquisition.

In the first situation, it may be that certain market, business or personal life cycle dynamics will keep one or both parties from wanting to sell the business. There is too much opportunity in the existing business to forego and owning a smaller percentage of a large pie is not an insurmountable hurdle. A merger gives both sets of ownership the value enhancements related to the expansion without forcing either group to exit their ownership position.

Mergers also have another very practical element. Cash is conserved because all or most of the consideration consists of shares issued by the surviving corporation to the shareholders of the company that will be merged into the surviving corporation. Some cash will be expended for professional fees, but the funds usually are nominal relative to the value of the combined companies. Importantly, existing excess liquidity and/or the borrowing capacity of the combined company can be used for expansion.

*Assuming the parties are comfortable with governance and social issues, a merger can be an excellent means to grow the business*

## Relative Value

In a merger transaction, there is a two-sided valuation question. While in an acquisition, the buying party is typically bringing cash to the transaction (cash being easy to value), the merger parties are effectively both paying for the transaction with stock. The value of both companies must be set to determine the relative value percentages. If Company A (valued at $110 million) merges with Company B (valued at $90 million), the relative value percentages are 55%/45%. Following the merger, the former Company A shareholders should have 55% of the equity ownership in the merged entity, with the former Company B shareholders holding the remaining 45%.

In addition to considering the stand-alone valuation of each company, a contribution analysis should be constructed based upon sales, EBITDA, equity and other financial metrics. The valuations and contribution analysis then provides a range of exchange ratios (or ownership percentages) to conduct negotiations.

While the valuation and contribution math may be straightforward (or not at all), negotiating merger transactions can be complicated since one party is not paid to go away. Mercer Capital is often hired on a joint basis by entities seeking to negotiate a merger transaction.

*Negotiating merger transactions can be complicated since one party is not paid to go away*

While the final decision to go through with the merger remains with our clients in this situation, we serve as an independent advisor to both sides of the merger to establish the relative value parameters. An independent assessment of the relative values can help tremendously in building confidence with shareholders and boards that the terms of the merger are reasonable for both sides.

## True-Ups

As with most deals, merger transactions usually include certain post-transaction “true-ups” to ensure that each entity delivers adequate levels of working capital (or other assets) at closing. A typical structure is for the parties to create escrow accounts funded with cash in amounts proportional to the post-merger ownership percentages. These escrow accounts serve as a mechanism to adjust for any shortfall at one entity.

If needed, a portion of the escrow cash is contributed into the merged entity, serving to make-up for any shortfall at closing. This keeps the ownership percentages at the agreed-upon relative value percentages. The excess cash left in the escrow accounts after these adjustments is distributed to the shareholders of the former (now merged) entities.

In our experience, shareholders and boards do not like the uncertainty of shifting ownership percentages – this escrow structure prevents the percentages from changing based on post-closing adjustments.

## Who Is in Charge?

As with any acquisition, an organized post-transaction integration is critical to the success of a merger. No matter how compelling the economics of a combination may be, the cultural fit of the two businesses will be a key element in determining the eventual success of the transaction. From the initial stages of the transaction, issues related to the cultural fit should be discussed and strategies should be implemented to increase the probability of a successful integration.

A basic question to be addressed early in the process is who will run the combined company. Public companies sometimes use co-CEOs, but not often for good reason. There should not be any question who is in charge, the responsibilities of subordinates, and the chain of command and accountability.

A comprehensive agreement on overall governance structures (including regional management, board construction, etc.) can provide some comfort for the side that might see themselves as being on the losing end of the potentially more political question of chief executive.

> *The cultural fit of the two businesses will be a key element in determining the eventual success of the transaction*

Shareholder control is another issue that has to be dealt with explicitly. If both entities consist of a large number of shareholders with no shareholder in direct control, the control issue is moot because there will be no controlling shareholder in the merged entity. Such prospective mergers are easier to negotiate because one shareholder (or voting block) does not have to give up control.

However, when one or both entities has a controlling shareholder (which could be represented by a single individual or a family block of stock), loss of control in a combined company may trump compelling economics. Both parties need to examine this issue closely and provide for conflict resolution mechanisms through the corporation's by-laws and buy-sell agreements. Like marriages, getting out of a transaction is a lot harder and more expensive than entering into it.

## Concluding Thoughts

We think mergers are a viable strategy to expand a business when the economics and social aspects are compelling for many small and middle market companies. Reasonable valuations and a detailed contribution analysis are the initial building blocks to quantify the economics.

# Check Out This Video!


What do you do if your business is approached by a potential acquirer? In this video, Nick Heinz presents four broad steps you should undertake to determine if the potential acquisition makes sense.

**WATCH NOW**

# THE IMPORTANCE OF A QUALITY OF EARNINGS STUDY

Acquirers of companies can learn a valuable lesson from the same approach that pro sports teams take in evaluating players. Prior to draft night, teams have events called combines where they put prospective players through tests to more accurately assess their potential. In this scenario, the team is akin to the acquirer or investor and the player is the seller. While a player may have strong statistics in college, this may not translate to their future performance at the next level. So it's important for the team to dig deeper and analyze thoroughly to reduce the potential for a draft bust and increase the potential for drafting a future all-star.

A similar process should take place when acquirers examine acquisition targets. Historical financial statements may provide little insight into the future growth and earnings potential for the underlying company. One way that acquirers can better assess potential targets is through a process similar to a sports combine called a quality of earnings study (QoE).

## What Is a Quality of Earnings Study?

A QoE study typically focuses on the economic earning power of the target. A QoE combines a number of due diligence processes and findings into a single document that can be vitally helpful to a potential acquirer. The QoE can help the acquirer assess the key elements of a target's valuation: core earning power, growth potential, and risk factors.

Ongoing earning power is a key component of valuation as it represents an estimate of sustainable earnings and a base from which long-term growth can be expected. This estimate of earning power typically considers an assessment of the quality of the company's historical and projected future earnings. In addition to assessing the quality of the earnings, buyers should also consider the relative riskiness, growth potential, and potential volatility of those earnings as well as potential pro-forma synergies that the target may bring in an acquisition.

*A QoE study typically focuses on the economic earning power of the target*

### Analysis performed in a QoE study can include the following:

1. **Profitability Procedures**. Investigating historical performance for impact on prospective cash flows. Historical EBITDA analysis can include certain types of adjustments such as: (1) Management compensation add-backs; (2) Non-recurring items; (3) Pro-forma adjustments/synergies.

2. **Customer Analysis.** Investigating revenue relationships and agreements to understand the impact on prospective cash flows. Procedures include: (1) Identifying significant customer relationships; (2) Gross margin analysis; and (3) Lifing analysis.

3. **Business and Pricing Analysis.** Investigating the target entities positioning in the market and understanding the competitive advantages from a product and operations perspective. This involves: (1) Interviews with key members of management; (2) Financial analysis and benchmarking; (3) Industry analysis; (4) Fair market value assessments; and (5) Structuring.

The prior areas noted are broad and may include a wide array of sub-areas to investigate as part of the QoE study. Sub-areas can include:

- Workforce / employee analysis
- A/R and A/P analysis
- Customer Analysis
- Intangible asset analysis
- A/R aging and inventory analysis
- Location analysis
- Billing and collection policies
- Segment analysis
- Proof of cash and revenue analysis
- Margin and expense analysis
- Capital structure analysis
- Working capital analysis

For high growth companies in certain industries such as technology, where valuation is highly dependent upon forecast projections, it may also be necessary to analyze other specific areas such as:

- The unit economics of the target. For example, a buyer may want a more detailed estimate or analysis of the target's key performance indicators such as cost of acquiring customers (CAC), lifetime value of new customers (LTV), churn rates, magic number, and annual recurring revenue/profit. These unit economics provide a foundation from which to forecast and/or test the reasonableness of projections.
- A commercial analysis that examines the competitive environment, go-to-market strategy, and existing customers' perception of the company and its products.

## Concluding Thoughts

The QoE study should be customized and tailored to the buyer's specific concerns as well as the target's unique situations. It is also paramount for the buyer's team to utilize the QoE study to keep the due diligence process focused, efficient, and pertinent to their concerns. For sellers, a primary benefit of a QoE can be to help them illustrate their future potential and garner more interest from potential acquirers.

# NEGOTIATING WORKING CAPITAL TARGETS IN A TRANSACTION

In middle market transactions, some of the most crucial points of negotiation are the net working capital targets agreed upon by the buyer and seller. Net working capital targets set a defined minimum amount of working capital that the buyer requires the seller to leave in the business at the close of a transaction.

Given that net working capital targets can have a direct effect on the final purchase price of a transaction, understanding the how and why of these types of negotiations is crucial for buyers looking to negotiate deals that not only look good at closing but also pass the test as the buyer takes over the operation of the newly acquired business.

## Defining Net Working Capital

Before negotiating working capital targets and benchmarks, it is important that the buyers, sellers, and their advisors in a deal setting have a clear understanding of what will and won't be included in net working capital for the purposes of closing the deal.

By the book, net working capital is defined as current assets less current liabilities. While this definition is acceptable for financial statement analysis and other accounting-adjacent applications, in the M&A universe, the most commonly used measure of net working capital is cash-free, debt-free net working capital. This is the standard definition of net working capital in a deal setting because it assumes that a seller will retain the cash in the business after paying off any short-term debts that the business owes. These debts could potentially include related party notes and lines of credit with banks.

In an M&A transaction, net working capital and net working capital targets are often defined terms in both the letter of intent and the purchase agreement. For buyers, it is crucial to understand these definitions because the basis of the net working capital calculation could directly affect the final purchase price.

## Why Are Net Working Capital Negotiations Necessary in a Deal?

Net working capital targets are necessary in deal settings because the amount of net working capital in a business often fluctuates from month-to-month and even week-to-week. Therefore, it is important that a benchmark or base level of net working capital to be left in the business at closing is agreed upon by both the buyer and the seller.

For example, a seller could aggressively collect accounts receivable in the months leading to closing in an effort to convert these receivables into cash. Conversely, a seller could let accounts payable inflate in the months leading to closing and theoretically retain a higher amount of cash. Even absent any sort of concentrated effort to impact the working capital, most companies have some level of fluctuation in their various balance sheet accounts. Setting a net working capital target negates the impact of these fluctuations and prevents the seller from "gaming" cash and working capital levels in anticipation of a transaction.

If net working capital levels at closing are not in line with the targets established in the negotiation process, an adjustment to the purchase price can be triggered.

The purchase price adjustment related to net working capital is typically applied after the close of the transaction – based on a final accounting as of the closing date. Usually, a defined amount of the purchase price is set aside in a short-term escrow specifically for any negative adjustment related to the final net working capital balance. If the final determination of net working capital comes in below the established threshold, then the buyer retains funds from the escrow to make up for this shortfall. If the final net working capital figure is above the threshold, the buyer makes an additional payment to the seller for the excess amount.

From the buyer's perspective, it is important to negotiate an escrow amount that is large enough to cover any potential swings in net working capital that could result at closing.

## Negotiating Net Working Capital Targets

The most practical and commonly used method of setting net working capital targets and benchmarks is to calculate a historical average amount of net working capital needed to fund a company's operations. This is most often done by calculating the average net working capital on a monthly basis over the twelve months preceding the valuation date used in the transaction.

Calculating an average over a historical period removes any seasonality effects and reveals a "normalized" level of net working capital needed to support the company's ongoing operations with no capital disruption. Since valuations are typically predicated on trailing twelve months EBITDA (or some other measure of earnings), it is typical that the look-back period for the net working capital target calculation coincides with the twelve-month period in which EBITDA is calculated. In other words, the calculation of a net working capital target should be on the same historical basis as that of the measure of earnings used to support the transaction value.

*It is important to negotiate an escrow amount that is large enough to cover any potential swings in net working capital that could result at closing.*

In situations where EBITDA from the most recent period is deemed to be unsustainable or if there is significant short-term growth underlying the transaction value, it might be necessary to calculate the net working capital benchmark by applying a percentage (based on historical averages) to an ongoing revenue figure in order to consider that net working capital needs will change as revenue either declines or increases post-closing.

While conducting due diligence, buyers may find potential adjustments to certain balance sheet items that comprise net working capital, which can affect the calculation of the net working capital target. Buyers will want to confirm that the seller has properly accrued (both historically and at closing) for certain items such as accrued vacation, payroll, bonuses, warranty obligations, etc. These potential adjustments can add another layer of complexity to the negotiation of net working capital targets, as buyers may find that there is an excess or deficiency of net working capital at certain points in the historical lookback period.

Sellers will often make the argument that they have historically operated with excess working capital based on comparisons to industry averages. Buyers should always approach any “excess” adjustment of this type with caution. It can be difficult to understand why the selling company would have operated with this “excess” when the capital could have been paid out to shareholders or invested in another way. With further analysis, there is often an explanation as to why the “excess” working capital has historically been carried on the company’s balance sheet.

As an example, the “excess” could have historically resulted from a quick turnover of payables such that the company has lower current liabilities than the industry average. The quick payments may have earned the company discounts from its vendors, which likely equated to higher profit margins. If the cash flow figures underlying the transaction value include the benefit of these discounts, then it could be double counting to adjust the net working capital to a “normalized” level.

One question that will arise in the negotiations is whether a specific dollar amount or a range should be utilized as the net working capital target. The logic of applying a range is straightforward – it prevents minor variances from creating a post-closing adjustment and reduces the likelihood of disagreements between the buyer and seller regarding the calculation of net working capital to the specific dollar. A word of caution on ranges: if the range is left too wide, it invites the same type of balance sheet “gaming” from the seller that the setting of a target was meant to prevent in the first place.

*The working capital of a business seems like it should be a simple concept, but it rarely is in practice.*

Our experience has been that, if a range is preferred, it should be tight enough that any amount that would be potentially gained from the closing working capital figure falling at the bottom or top of the range should be immaterial to both the buyer and the seller.

## Concluding Thoughts

The working capital of a business seems like it should be a simple concept, but it rarely is in practice. Negotiating net working capital is a critical element in working towards a close on a transaction.  Buyers should work carefully to understand the working capital needs of the operations that they are acquiring. This knowledge will give them and their advisors the insight to negotiate an appropriate working capital target and to insure adequate funds are es-crowed to counter any working capital surprises at closing.

# CONSIDERING CONTINGENT CONSIDERATION

Contingent consideration is a common feature of M&A when both parties are private, or the acquirer is public, and the target is private. There are many forms of contingent consideration in M&A. These include post closing purchase price adjustments that can alter total transaction value or that can alter the payment and realization of net proceeds through the recovery of transaction set-asides such as escrow balances or the payment of holdbacks and deferrals.

## What Do Earnouts Entail?

The most common contingent payment is an “earn-out” that bridges the buyer’s bid and the seller’s ask by ensuring the business produces an agreed upon level of revenues and/or earnings (typically EBITDA) within an agreed time frame before the payment is made.

Earn-outs could be considered the ultimate form of confirmatory due diligence. From a buyer’s perspective, earn-outs reduce risk by reducing up-front cash and the likelihood of materially overpaying absent an adverse turn in the economy or industry conditions. From a seller’s perspective, contingent consideration allows sellers to obtain an acceptable price and sometimes a premium or stretch valuation if the Company attains the agreed-upon targets. Further, earnouts create an alignment of interests to the extent roll-over management and ownership is incented to optimize the company’s performance.

In our experience, most buyers are willing to pay in a range of value that produces an acceptable return based upon conservative assumptions about the business’ future earning power (EBITDA or EBITDA less capex) and growth rate. Unless the business is viewed as having above average risk, most buyers’ required rate of return on an unlevered basis will be conservative but not ridiculously high. This reflects buyers’ natural aversion to risks that may not be readily apparent to most sellers. An earn-out is a means by which to close or narrow this gap.

When earnouts are involved, buyers and sellers must understand the waterfall of post-closing events, and their respective timing and terms to gain a full understanding of transaction consideration. Earnouts are a form of purchase consideration where acquirers tender value to the target seller if certain future events occur. Earnouts provide sellers with potential value fulfillment or upside while simultaneously allowing buyers to defer payment of consideration with the possibility of recovering a designated portion of the purchase price if post-closing hurdles are not achieved.

By its nature, contingent consideration adds complexity for both buyers and sellers, particularly when the features of the earnout reflect significant speculation on post-closing outcomes. These might include high growth, reversals of trend, or specific events such as new business developments or failed business retention.

Despite the complexities, earnouts and other forms of contingent consideration can be critical to achieving a successful closing when market conditions are ebbing more than flowing or when winning the day requires the buyer to make a stretch offer.

## Mid-Market Deals Increasingly Reflect Up-Market Deal Structures

According to GF Data®, a firm that provides data on private equity-sponsored M&A transactions with an enterprise value of $10 to $250 million, 38% of 432 transactions in 2021 entailed either seller financing or earnouts compared to 44% of 329 deals in 2020. The reduction last year reflected a seller's market that was characterized by too much capital chasing a limited pool of sellers. Given tighter financial conditions this year that may lead to a recession later this year or next, it would not surprise us to see the percentage of deals with an earnout increase because the risk to a target's earnings and maybe long-term growth prospects will rise.

A financial advisor can be an important intermediary for both buyer and seller to craft a well structured earnout to facilitate successful deal negotiations rather than letting a poorly crafted and/or poorly socialized earnout create a negotiation wedge that can delay or overwhelm momentum required to finalize a purchase agreement.

## Buyer Awareness and Financial Reporting

While it should not impact the economics of a transaction, buyers face the added burden of accounting for contingent consideration per FASB's ASC 805, which addresses business combinations. It requires that the fair value of contingent consideration be recorded as a liability at the acquisition date, resulting in an increased amount of goodwill or other intangible asset depending upon how value is allocated to the acquired assets. Fair value also must be re-measured for each subsequent reporting period until the contingency is settled. Mercer Capital's years of M&A purchase price allocation work for both strategic and financial acquirers gives us unique insight into the sometimes nettlesome issues of purchase price allocations in M&A transactions.

## Concluding Thoughts

While this section is a larger part of our buy-side series of content, it is important to draw advice for buyers from our near universal advice to sellers.

We often advise sellers to be content with the consideration they receive at closing and to assess contingent consideration with a healthy degree of skeptical risk, particularly when achieving the earnout represents a stretch in future outcomes.

A logical extension of that advice for buyers is to be prepared to pay even if the benchmarks are deemed a stretch. The occasional extraordinary outcome can create significant buyer liability. Whether the net effect on the buyer is a beneficial deferral of payment or a deal premium (or otherwise) must be assessed in the context of the overall offering stack.

Buyers should determine the reason for using an earnout and then determine an appropriate design for the earnout. Clear, unambiguous terms and measurements are recommended to minimize negotiating friction and incent smooth post-closing integration and alignment of interests both operationally and financially.

# BUY-SIDE FAIRNESS OPINIONS

Directors are periodically asked to make tough decisions about the strategic direction of a company. Major acquisitions are usually one of the toughest calls boards are required to make.

A board's fiduciary duty to shareholders is encapsulated by three mandates:

- Act in good faith;
- Duty of care (informed decision making); and
- Duty of loyalty (no self-dealing; conflicts disclosed).

Directors are generally shielded from courts second guessing their decisions by the business judgment rule provided there is no breach of duty to shareholders. The presumption is that non-conflicted directors made an informed decision in good faith. As a result, the burden of proof that a transaction is not fair and/or there was a breach of duty resides with the plaintiffs.

An independent fairness opinion helps demonstrate that the directors of an acquiring corporation are fulfilling their fiduciary duties of making an informed decision.

Fairness opinions seek to answer the question whether the consideration to be paid (or received from a seller's perspective) is fair to a company's shareholders from a financial point of view. Occasionally, a board will request a broader opinion (e.g., the transaction is fair).

A fairness opinion does not predict where the buyer's shares may trade in the future. Nor does a fairness opinion approve or disapprove a board's course of action. The opinion, backed by a rigorous valuation analysis and review of the process that led to the transaction, is just that: an opinion of fairness from a financial point of view.

## Delaware, the SEC, and Fairness

Fairness opinions are not required under Delaware law or federal securities law, but they have become de rigueur in corporate M&A ever since the Delaware Supreme Court ruled in 1985 that directors of TransUnion were grossly negligent because they approved a merger without adequate inquiry and expert advice. The court did not specifically mandate the opinion be obtained but stated it would have helped the board carryout its duty of care had it obtained a fairness opinion regarding the firm's value and the fairness of the proposal.

The SEC has weighed in, too, in an oblique fashion via comments that were published in the Federal Register in 2007 (Vol. 72, No. 202, October 19, 2007) when FINRA proposed rule 2290 (now 5150) regarding disclosures and procedures for the issuance of fairness opinions by broker-dealers. The SEC noted that the opinions served a variety of purposes, including as indicia of the exercise of care by the board in a corporate control transaction and to supplement information available to shareholders through a proxy.

## Dow's Sour Pickle

Buy-side fairness opinions have a unique place in corporate affairs because the corporate acquirer has to live with the transaction. What seems fair today but is deemed foul tomorrow, may create a liability for directors and executive officers. This can be especially true if the economy and/or industry conditions deteriorate after consummation of a transaction.

For instance, The Dow Chemical Company ("Dow"), a subsidiary of Dow Inc. (NYSE: DOW), agreed to buy Rohm and Haas ("RH") for $15.4 billion in cash on July 10, 2008. The $78 per share purchase price represented a 75% premium to RH's prior day close. The ensuing global market rout and the failure of a planned joint venture with a Kuwait petrochemical company led Dow to seek to terminate the deal in January 2009 and to cut the dividend for the first time in the then 97 years the dividend had been paid.

Ultimately, the parties settled litigation and Dow closed the acquisition on April 1, 2009 after obtaining an investment from Berkshire Hathaway (NYSE: BRK.A) and seller financing via the sale of preferred stock to RH's two largest shareholders.

Dow was well represented and obtained multiple fairness opinions from its advisors (Citigroup, Merrill Lynch and Morgan Stanley). One can question how the advisors concluded a 75% one-day premium was fair to Dow's shareholders (fairness is a mosaic and maybe RH's shares were severely depressed in the 2008 bear market). Nonetheless, the affair illustrates how vulnerable Dow's Board of Directors or any board would have been absent the fairness opinions.

## Fairness and Elon

Before Elon Musk reneged on his planned acquisition of Twitter, Inc. (NYSE: TWTR) on July 8, 2022, one of the most recent contentious corporate acquisitions was the 2016 acquisition of SolarCity Corporation by Tesla Inc. (NASDAQGS: TSLA). Plaintiffs sought up to $13 billion of damages, arguing that (a) the Tesla Board of Directors breached its duty of loyalty, (b) Musk was unjustly enriched (Musk owned ~22% of both companies and was Chairman of both); and (c) the acquisition constituted waste.

Delaware Court of Chancery Judge Joseph Slights ruled in favor of Tesla on April 27, 2022. Slights noted courts are sometimes skeptical of fairness opinions; however, he was not skeptical of Evercore's opinion, noting extensive diligence, the immediate alerting of the Tesla Board about SolarCity's liquidity situation and the absence of prior work by Evercore for Tesla.

## Concluding Thoughts

Fairness is a relative concept. Some deals may be marginally fair (or unfair), others may be very fair, while many will be reasonable in the sense that fairness is in the middle of the fairway; otherwise the parties would not strike a deal. Nonetheless, fairness opinions and an accompanying fairness analysis that entails a deep-dive into a proposed transaction are important elements for directors to consider when evaluating a significant transaction.

PRESENTATION

# Tesla Walks the Entirely Fair Line with SolarCity

In March of 2016 Elon Musk was laying the ground work for the merger of Telsa, Inc. and SolarCity Corporation. This presentation looks at the issues raised by plaintiffs who alleged Musk orchestrated the deal to bail-out SolarCity, and how the Delaware Court of Chancery ruled on the issues on April 27, 2022 under the entire fairness standard rather than deferential business judgment rule.

>> VIEW PRESENTATION

# BUY-SIDE SOLVENCY OPINIONS

With the potential rise of corporate bankruptcies, if the U.S. enters a sufficiently deep recession next year, debt funded acquisitions and dividend recap transactions that were common the past couple of years after rates plunged may be subject to intense scrutiny. Of course, if there is no recession or only a shallow recession, then these musings may be premature.

Nonetheless, acquirers who anticipate levering a target's capital structure and owners who are contemplating a dividend recap should be familiar with solvency opinions and the concept of fraudulent conveyance, concepts that were litigated in the 2020 bankruptcy of Neiman Marcus.

## What Is a Solvency Opinion?

*The Business Judgment Rule*, an English case law doctrine followed in the U.S. and Canada, provides directors with great latitude in running the affairs of a corporation provided directors do not breach their fiduciary duties to act in good faith, loyalty and due care. However, there are instances when state law prohibits certain actions including the fraudulent transfer of assets to stockholders that would leave a company insolvent.

This straightforward statutory prescription has taken on more meaning over the past decade because Corporate America has significantly increased its use of debt given very low interest rates. Investors have been willing to fund the increase because negligible rates on "safe" assets have pushed individuals and institutions further out the risk curve to produce income.

Transactions that may meaningfully alter the capitalization of a company include leveraged dividend recapitalizations, leveraged buyouts, significant share repurchases, and special dividends funded with existing assets. Often a board contemplating such actions will be required to obtain a solvency opinion at the direction of its lenders or corporate counsel to provide evidence that the board exercised its duty of care to make an informed decision should the decision be challenged.

### A Solvency Opinion Addresses Four Questions

1. Does the fair value of the company's assets exceed its liabilities after giving effect to the proposed action?
2. Will the company be able to pay its debts (or refinance them) as they mature?
3. Will the company be left with inadequate capital?
4. Does the fair value of the company's assets exceed its liabilities and surplus to fund the transaction?

A solvency opinion is typically performed by a financial advisor who is independent, meaning the advisor has not arranged financing or provided other services related to the contemplated transaction. The opinion is based upon financial analysis to address the valuation of the corporation and its cash flow potential to assess its debt service capacity.

Also, the opinion is just that—it is an informed opinion. It is not a pseudo statement of fact predicated upon the "known" future performance of the Company. It provides a reasonable perspective concerning the future performance of the Company while neither promising to stakeholders that those projections will be met, nor obligating the Company to meet those projections.

## Test 1: The Balance Sheet Test

*Does the fair value and present fair saleable value of the Company's total assets exceed the Company's total liabilities, including all identified contingent liabilities?*

The balance sheet test is a valuation test in which the value of the company's liabilities are subtracted not from the assets recorded on the balance sheet, but rather the fair market value of the firm on a total invested capital basis. The value of the firm on a debt-free basis is estimated via traditional valuation methodologies, including Discounted Cash Flow ("DCF"), Guideline Public Company and Guideline Transactions (M&A) Methods. In some instances, the Net Asset Value ("NAV") Method may be appropriate for certain types of holding companies in which assets can be marked-to-market.

## Test 2: The Cash Flow Test

*Will the Company be able to pay its liabilities, including any identified contingent liabilities, as they become due or mature?*

This question addresses whether projected cash flows are sufficient for debt service. A more nuanced view evaluates the question along three general dimensions:

**Revolver Capacity**: If financial results approximate the forecast, does the Company have sufficient capacity, relying upon its revolving credit facility if necessary, to manage cash flow needs through each year?

**Covenant Violations:** Does the projected financial performance imply that the Company will violate covenants of the credit or loan agreement, or the terms of any other credit facility currently in place or under consideration as part of the subject transaction?

**Ability to Refinance:** Is it likely that the Company will be able to refinance any remaining balance at maturity?

## Test 3: The Capital Adequacy Test

*Does the Company have unreasonably small capital with which to operate the business in which it is engaged, as management has indicated such businesses are now conducted and as management has indicated such businesses are proposed to be conducted following the transaction?*

The capital adequacy test is related to the cash flow test. A company may be projected to service its debt as payments come due, but a proposed transaction may leave the margin to do so too thin to address operating needs—something many companies discovered this year during which they were able to operate with high leverage as long as business conditions were favorable.

There is no bright line test for what “unreasonably small capital” means. We typically evaluate this concept based upon pro forma and projected leverage multiples (Debt/EBITDA and EBITDA/Interest Expense) relative to public market comps and rating agency benchmarks. While management’s projections represent a baseline scenario, alternative downside scenarios are constructed to asses the “unreasonably small capital” question in the same way downside scenario analyses are constructed to address the question of whether debts can be paid or refinanced when they come due.

## Test 4: The Capital Surplus Test

*Does the fair value of the Company’s assets exceed the sum of (a) its total liabilities (including identified contingent liabilities) and (b) its capital (as such capital is calculated pursuant to Section 154 of the Delaware General Corporation Law)?*

The capital surplus test replicates the valuation analysis prescribed under the balance sheet test, but also includes the Company’s capital in the subtrahend (Hey! There is a word we haven’t seen since early primary school. The subtrahend is the value being subtracted.)

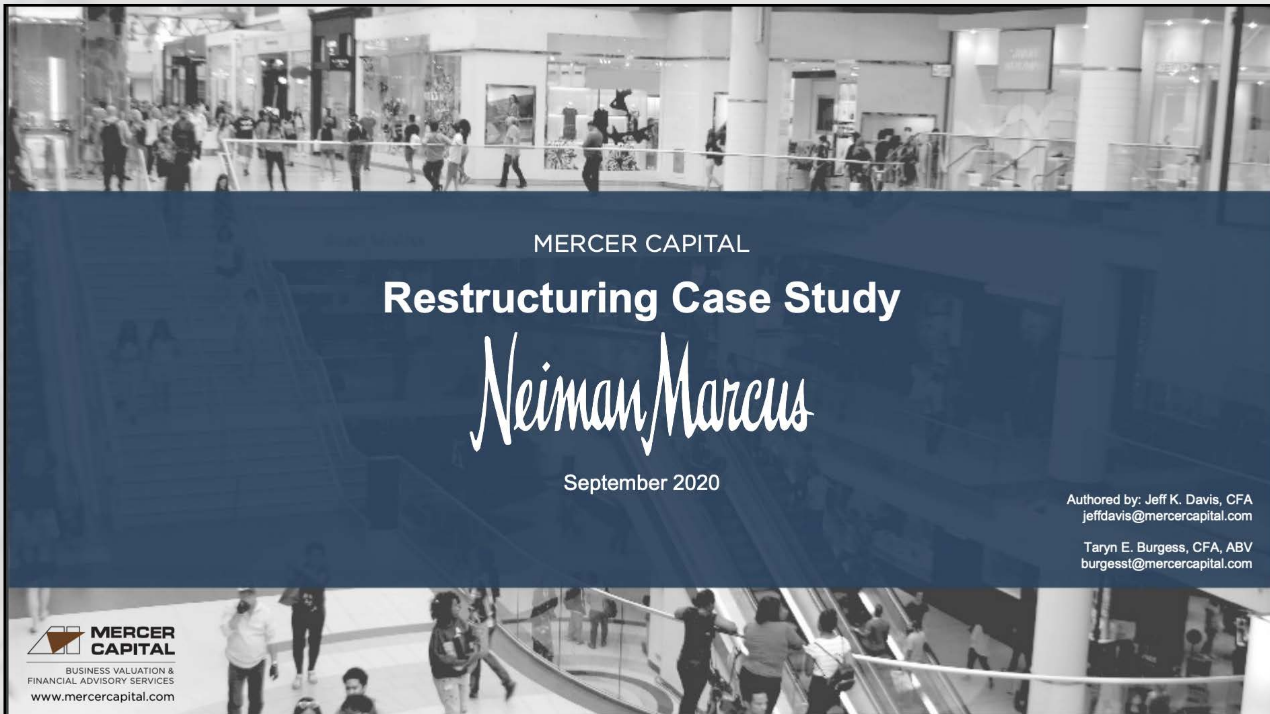
Section 154 of the Delaware General Corporation Law defines statutory capital as (a) the par value of the stock; or in stances when there is no par value as (b) the entire consideration received for the issuance of the stock. Capital as defined here is nuanced. Often it may be a small amount if par is some nominal amount such as a penny a share, but that may not always be the case. What is excluded is retained earnings (or deficit) from the equity account.

## Concluding Thoughts

The tests described above are straightforward. Sometimes proposed transactions are straightforward regarding solvency, but often it is less clear—especially when the subject company operates in a cyclical industry. Every solvency analysis is unique to the subject transaction and company under review and requires an objective perspective to address the solvency issue. Not only is a solvency opinion a prudent tool for board members and other stakeholders, but the framework of solvency analysis is ready made to score strategic alternatives and facilitate capital deployment.

# A Restructuring Case Study

Neiman Marcus




On May 7, 2020, Neiman Marcus, an iconic luxury retailer, announced in its bankruptcy filing plans to reorganize under Chapter 11 with the backing of most creditors. In this study, we discuss the bankruptcy process and the importance of valuation in bankruptcy proceedings.

>> View Study

# PURCHASE PRICE ALLOCATIONS TO ACQUIRERS

Growing up an avid sports fan, I always enjoyed picking up the paper and flipping to the sports section to see the box scores from the prior day's games. While the headline score told you who won or lost, the box score gave more information and insights into who played well and the narrative of the game. For example, the box score might tell you that even though your favorite team won, they were dominated by the other team in all the categories except turnovers, or that the team that lost actually "won" each quarter except the fourth and their star player had a bad game.

In my view, a purchase price allocation is similar to a box score in that it provides greater detail from which to derive insights on a particular transaction. While a purchase price allocation (PPA) analysis is primarily an accounting (and compliance driven) exercise, it is also a window into the objectives and motivations behind the transaction. When used proactively and/or during the M&A process, the disciplines of PPA analysis can provide buyers with important perspective concerning the unique value attributes of the target's intangible asset base, which can help rationalize strategic acquisition consideration or forewarn of potentially unstable or short-lived intangible asset value.

In this section we explore PPAs further with a broad overview and then a deeper look into the pitfalls and best practices related to them.

## Introduction to PPAs

Acquirers conduct PPAs to measure the fair value of various tangible and intangible assets of the acquired business. Any excess of the total asset value implied by the transaction over the fair values of identified assets is ascribed to the residual asset, goodwill.

**Intangible assets commonly identified and measured as part of PPA analyses include:**

- **Trade name** – Trade name intangibles may be valuable if they enhance the expected future cash flows of the firm, either through higher revenue or superior margins. The relief from royalty method, which seeks to simulate cost savings due to the ownership of the name, is frequently used to measure the value of trade names.
- **Customer relationships** – Customer relationships can be valuable because of the expectation of recurring revenue.
- **Technology** – Technologies developed by the target business are valuable because the acquirer avoids associated development or acquisition costs. Patents and other forms of intellectual property may provide legal protection from competition and help secure uniqueness and/or differentiation.
- **IPR&D** – Ongoing R&D projects can give rise to in-process research and development intangible assets, whose values are predicated on expected future cash flows.
- **Contractual assets** – Contracts that lock in pricing advantages – above market sales prices or below market costs – create value by enhancing cash flow.

- **Employment / Non-competition agreements –** Employment and non-competition agreements with key executives ensure a smooth transition following an M&A transaction, which can be vital in reducing the likelihood of employee or customer defection.

The value of an enterprise is often greater than the sum of its identified parts (both tangible and intangible), and the excess is usually reflected in the residual asset, goodwill. GAAP goodwill also captures facets of the target that may be value-accretive, but do not meet certain criteria to be identified as an intangible asset. Notably, fair value measurement presumes a market participant perspective. Goodwill may also include acquirer-specific synergistic or strategic considerations that are not available to other market participants. Consequently, goodwill has tended to account for a significant portion of allocated value in truly strategic business combinations.

## Pitfalls and Best Practices of PPAs

Below we highlight some pitfalls and best practices gleaned from providing purchase price allocations to acquirers since the advent of fair value accounting.

### What are some of the pitfalls in purchase price allocations?

Sometimes differences arise between expectations or estimates prior to the transaction and fair value measurements performed after the transaction. An example is contingent consideration arrangements – estimates from the deal team's calculations could vary from the fair value of the corresponding liability measured and reported for GAAP purposes. To the extent amortization estimates are prepared prior to the transaction, any variance in the allocation of total transaction value to amortizable intangible assets and non-amortized, indefinite lived assets – be they identifiable intangible assets or goodwill – could also lead to different future EPS estimates for the acquirer.

### What are the benefits of looking at the allocation process early?

The opportunity to think through and talk about some of the unusual elements of the more involved transactions can be enormously helpful. Similar to a coach who may look at the box score from the first half of a game during the halftime break, we view the dialogue we have with clients when we prepare a preliminary PPA estimate prior to closing as a particularly important part of the M&A project. This deliberative process results in a more robust – well-reasoned analysis that is easier for the external auditors to review, and better stands the test of time requiring fewer true-ups or other adjustments in the future. Surprises are difficult to eliminate, but as they say, forewarned is forearmed.

### Can goodwill be broken into different components?If so, what are the different components and how are they delineated?

In the world of FASB, goodwill is not delineated into personal goodwill and corporate or enterprise goodwill. However, in the tax world, this distinction can be of critical importance and can create significant savings to the sellers of a C corporation business.

Many sellers prefer that a transaction be structured as a stock sale, rather than an asset sale, thereby avoiding a built in gains issue and its related tax liability. Buyers want to do the opposite for a variety of reasons. When a C corporation's assets are sold, the shareholders must realize the gain and face the issue of double taxation whereby the gain is taxed at both the corporate level, and again at the individual level when proceeds are distributed to the shareholders. Proceeds that can be allocated to the sale of a personal asset, such as personal goodwill, may mitigate the double taxation issue.

*Proceeds that can be allocated to the sale of a personal asset, such as personal goodwill, may mitigate the double taxation issue*

The Internal Revenue Service defines goodwill as "the value of a trade or business based on expected continued customer patronage due to its name, reputation, or any other factor." Recent Tax Court decisions have recognized a distinction between the goodwill of a business itself and the goodwill attributable to the owners/professionals of that business. This second type is typically referred to as personal (or professional) goodwill (a term used interchangeably in tax cases).

Personal goodwill differs from enterprise goodwill in that personal goodwill represents the value stemming from an individual's personal service to that business, and is an asset owned by the individual, not the business itself. This value would encompass an individual's professional reputation, personal relationships with customers or suppliers, technical expertise, or other distinctly personal abilities which provide economic benefit to a business. This economic benefit is in excess of any normal return earned on other tangible or intangible assets of the company.

### What other problems/issues beyond a PPA can you help acquirers navigate?

As part of our full suite of services for acquirers, we can handle a number of different kinds of special projects that corporate finance departments may be looking to outsource, completely or partially. For example, our firm helps clients think through certain financial or strategic questions – what level of cash flow reinvestment will best balance competing shareholder interests? Or, what is the appropriate hurdle rate when evaluating internal projects vs. acquisitions for capital budgeting exercises? In other instances, we perform financial due diligence and quality of earnings analyses for transactions.

## Concluding Thoughts

As the "box score" of transactions, PPAs can be an important tool for acquirers and provide greater insight into the motivations and narrative behind a transaction by illustrating the value of various intangible components of a business beyond the collection of tangible assets and how those compare to the purchase price being paid. Our purchase price allocations can be more robust with fewer surprises when we have also worked with the clients before the close of the transaction on elements such as financial due diligence or contingent consideration estimates, or even broader corporate finance and PPA studies.

# CONCLUSION

Mercer Capital provides M&A advisory services to a wide spectrum of public and private companies and financial institutions. We have worked on hundreds of transaction engagements since our founding in 1982.

We leverage our valuation and investment banking experience to help clients navigate the transaction environment, consistently providing timely, wealth-changing outcomes. We have significant experience advising shareholders, boards of directors, senior executives, and fiduciaries of middle-market public and private companies in a wide range of industries. We understand the complications and opportunities in today's markets where private equity groups, family offices, and strategic buyers are increasingly in each other's footprint (and in everyone's email inbox!).

Mercer Capital postures itself as an objective advisor to its clients in buy-side situations while simultaneously examining the risks and benefits of each strategic alternative and taking aggressive positions with potential sellers when warranted and beneficial to the process. We facilitate balanced decision-making for our clients while taking care to recognize the crucial milestones at which challenging choices must be made.

Mercer Capital's multi-phased, tailored approach allows current and future buyers a wide range of options in planning for, testing, and acting in the market. Our advisory team is here to plan for and manage your transaction process. To discuss your situation in confidence, give us a call.

# Mercer Capital

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