In July of 2005, Fred Wilson wrote a post on his website, A VC, 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. 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.

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.

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™
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.

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

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