

Using the Recession to Prepare For Your Liquidity Event

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How Bad is it?

Where we've been (private equity):

- 75 funds of \$5 billion or more raised 2003-2007
- 58 deals of \$5 billion or more completed 2003-2007 (up 5,700% from 1996 – 2000 period)
- 2003-2007 13,000 deals completed (up 140% from 1996– 2000 period)
- Debt/EBITDA multiples increased by 50% from 2001 (4.1x Debt/EBITDA average) to 2007 (6.2x Debt/EBITDA average)
- Purchase price/EBITDA multiples increased 62% from 2001 (6.0x average) to 2007 (9.7x average)

Source: Thomson Venture Economics, data as of 12/31/08; Capital IQ; Dealogic, data for sponsor-entry transactions; S&P LCD; Private Equity Council, Primer 2007 as summarized by The Carlyle Group (February 4, 2009).

How Bad is it?

Where we are (private equity):

- Global deal value declined from \$738 billion in 2007 to \$212 billion in 2008 (71% decrease)
- Commitments to new funds declined from \$152 billion committed in first quarter of 2008 compared to \$49 billion committed in last quarter of 2008 (67% decrease)
- Distributions decreased from 3Q07 to 4Q08 by 78%

Source: Thomson Venture Economics, data as of 12/31/08; Capital IQ; Dealogic, data for sponsor-entry transactions; S&P LCD; Private Equity Council, Primer 2007 as summarized by The Carlyle Group (February 4, 2009).

How Bad is it?

Where we are (leverage):

- Debt/EBITDA multiples in large LBOs decreased from 6.2x in 2007 to 4.9x in 2008
- Equity as a percentage of total purchase price increased from 29.9% in 2006 to 38.1% in 2008.

Source: S&P LCD, leverage data for U.S. large corporate LBOs (issuer w/EBITDA >\$50M), equity data for all U.S. LBOs with total sources > \$1 billion as summarized by The Carlyle Group (February 4, 2009).

How Bad is it?

The Middle Market

- Q408 total middle market M&A deal volume decreased 66% over Q407
- Number of deals decreased 56% from Q407 to Q408
- Middle market M&A valuation multiples declined from Q307 peak of 8.0x EBITDA to 5.8x EBITDA in Q408
- Smaller market deals (<\$100 million total transaction size) decreased by 42% in 4Q08 from 4Q07

Source: D.A. Davidson & Co. Investment Banking, The Dealmaker, Q42008

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When will it end?

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H. M. Jones

"Ed, this is Art Simbley over at Hollis, Bingham, Cotter & Krone. What did you get for thirty-four across, 'Persian fairy,' four letters?"

What will change?

Fundamental changes are likely in private equity:

- Fund investment is down as a result of concerns about liquidity, diminished returns, and concerns about PE's ability to achieve historical returns on investment
- PE Fund focus is on portfolio management rather than raising new funds or deploying additional cash
- Leverage at historical levels will be very difficult in terms of both acquisition leverage (3.0 to 5.0x), and overall leverage will continue to reduce from historical levels
- As leverage decreases, ROI is more difficult to achieve in PE model

What will change?

Fundamental changes are likely in private equity (cont'd):

- New and more strident regulation of financial institutions could constrain credit more
- To the extent leverage is available, terms will be substantially more stringent than during 2003-07
- Where control is purchased, 45-50% equity will be required
- More PE participation in minority recaps
- Distributions will be fewer and exit horizons will be longer

What will change?

Strategic deals will continue, but:

- With decreased competition from financial buyers for the same targets, purchase price multiples will decrease
- Even financially strong strategics will conserve cash and delay acquisitions, where possible, until upturn
- Strategics may consider non-M&A alternatives to preserve relationships and downstream purchase opportunities
- Overall credit constrictions and debt covenants will prevent many strategics from transacting

What will change?

Small Market

- Deal flow will continue because of ability of both strategic and financial buyers to come up with purchase price with less leverage
- Abundance of specialty funds providing tiered financing options
- Largest threat is ongoing availability of senior debt from traditional sources, even with stringent debt terms.
- All buyers will be more selective
- Multiples will decrease in approximate relationship to declining multiples on large deals

What to do in the meantime?

1. Assess the need and timing for a liquidity event
2. Identify the most likely type of liquidity event
3. Assemble a team
4. Identify and resolve problems and weaknesses
5. Stay profitable (or alive) and wait

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Need for Sale

- Retirement
- Family issues
- Diversification/estate planning
- Lack of financing to move forward
- Financial trouble

Timing of Sale

- Planning and preparation should start 12-24 months in advance of desired closing date
- Team should be assembled 9-12 months in advance
- Actual time to closing will depend on the structure of transaction and market conditions
 - 4-6 month transaction process is ideal
 - 9-12 month process common for small targets

Identify Most Likely Type of Event

- Stock or asset sale or Merger
 - Financial buyer
 - Strategic buyer
- IPO (?)
- Recapitalization (majority or minority; leveraged or equity)
- Reverse merger (?)

Assemble a Team

- Management
- Legal
- Accounting
- Investment Banking

Management

Two important considerations:

- Deal Concerns
 - Can current management successfully execute a deal (experience, capacity, judgment, loyalty, discretion, confidentiality)
 - Financial management and reporting (projections, fluency with target's operations)
- Operational Concerns
 - Can current management provide the foundation for the investment thesis of the buyer
 - Continuity
 - Future development

Legal

Always

- In-house counsel
- Outside general
- M&A
- Tax

When Applicable

- IP
- ERISA/Benefits
- Environmental
- Regulatory
- Antitrust
- Litigation
- Real Property

Accounting

- CFO/Controller
 - Revenue recognition
 - Tax
 - Cash flow
 - Balance sheet
- Transaction Tax
- GAAP
- Audit

Investment Banking

Advantages of IB Engagement

- ***Help Prepare a Company for Sale*** -- Identify deal kill issues early
- ***Knowledge of Market Conditions*** -- determine optimal timing; manage expectations of owners regarding multiples, leverage, market conditions
- ***Reduce Distraction*** – Remove much of sale process from management to enable operating of business
- ***Discreet Marketing Process*** – Can facilitate “water testing” on no names basis before market taint or employee knowledge
- ***Professional Negotiation*** – Typically will be better at negotiating business terms than management, accounting or legal advisors.

Investment Banking

Advantages of IB Engagement (Cont'd)

- ***Preserve Seller's Relationship with Buyer*** -- Buffers difficult negotiations as a third party.
- ***Add Structure to the Process*** – If reputable will bring credibility and discipline to a difficult process.
- ***Create a Competitive Dynamic*** -- Create real or perceived competition for the deal – shortens process, maximizes value, reduces execution risk.
- ***Provide Creative Structures to Maximize Value*** -- Can propose alternative deal structures to allocate risks and address challenges.

Investment Banking

Disadvantages/Risks of IB Engagement

- **Cost** – Depending on deal size, most small market transactions will be 2% to 5%+ for commission plus expenses.
- **Loss of Control** – Owners and management can feel out of control of process.
- **Lack of Credibility** – if the wrong IB is engaged, can lose credibility in relevant community.
- **Potentially Conflicting Interests** – Commission structure can create divergent interests from owner/management if IB is not disciplined, professional and ethical

Process Overview

PROCESS	ADVANTAGES	DISADVANTAGES
<p>BROAD</p> <ul style="list-style-type: none"> ◆ Approach broad group of potential acquirors/investors. ◆ Conduct all discussions in parallel. ◆ Maintain strict timing and procedures. ◆ Orchestrate highly competitive process. 	<ul style="list-style-type: none"> ◆ Most likely to yield highest valuation. ◆ Limits acquirors'/investors' ability to assess negotiating position of seller. ◆ Strict control over timing and procedures. ◆ Creates greatest sense of urgency. 	<ul style="list-style-type: none"> ◆ Failed process creates “shop-worn” company. ◆ Rigid schedule may eliminate some logical potential acquirors/investors. ◆ Loss of leverage if timing and procedures are modified due to weak interest. ◆ Most difficult to maintain confidentiality. ◆ Most disruptive to business and employees.
<p>FLEXIBLE</p> <ul style="list-style-type: none"> ◆ Approach selected group of potential acquirors/investors. ◆ Conduct initial discussions in parallel. ◆ Maintain flexibility in timing and procedures. ◆ Encourage capital providers to take “preemptive” posture. ◆ Transition into broader auction process based on initial indications. 	<ul style="list-style-type: none"> ◆ Signals credible alternatives to prospective capital providers and creates a sense of urgency. ◆ Potential opportunity to capture “preemptive” value. ◆ Flexibility in timing and procedures. ◆ Reduces risk of failed process. 	<ul style="list-style-type: none"> ◆ Potential disruption to business and employees. ◆ Reduced ability to maintain confidentiality. ◆ Potential loss of control over timing and procedures. ◆ Potentially diminish opportunity to realize maximum value.
<p>NEGOTIATED</p> <ul style="list-style-type: none"> ◆ Identify “short list” of potential acquirors/investors. ◆ Initially conduct exclusive negotiations with preferred groups. ◆ If unsuccessful, conduct negotiations with other capital providers in sequence. 	<ul style="list-style-type: none"> ◆ Greatest ability to maintain confidentiality. ◆ Least disruptive to business and employees. ◆ Ability to quickly determine most likely acquirors'/investors' respective levels of interest. ◆ Potential opportunity to capture “preemptive” value. 	<ul style="list-style-type: none"> ◆ Necessitates high degree of Management involvement. ◆ Limited control over timing and procedures. ◆ May not create a competitive environment or sense of urgency. ◆ May not maximize value.

Process Overview

Basic Steps

1. Internal diligence and preparation
2. Confidential Information Memorandum
3. Non-disclosure Agreement
4. Identify buyers
5. Distribution of information/communication with potential investors
6. Receipt of indications of interest
7. Preliminary external diligence
8. Letter of intent
9. Negotiation of definitive agreement
10. Completion of diligence
11. Closing

Identify Problems and Weaknesses

Key concerns:

- Capitalization
- Intellectual property
 - Patent and trademark applications filed
 - Licenses obtained
 - Employee invention assignments
 - Infringement analysis
 - Confidentiality agreements/trade secret protection
- Analysis of key contracts (leases, loans, financings, licenses) for consents or required amendments

Identify Problems and Weaknesses

Key concerns (cont'd):

- Corporate books and records
 - Minute books, stock ledger
- Legal compliance
 - Labor/Employment
 - ERISA/benefits
 - Contract compliance
 - Securities law compliance
 - Regulatory
 - Environmental

Identify Problems and Weaknesses

Key concerns (cont'd):

- Tax
- Employee equity plans
 - Document and implement before “cheap stock” problems arise
 - Document oral arrangements
- Equity ownership and conflicts among or within
- Permits and licenses

Identify Problems and Weaknesses

Key concerns (cont'd):

- Management team
 - Holes (finance, sales, operations)
 - Continuation
- Operating inefficiencies
 - Outsourcing possibilities
 - Expense reduction
- EBITDA Adjustments
- Accounting issues

Identify Problems and Weaknesses

Key concerns (cont'd):

- IT Systems
- Capital expenditure budget and needs
- Projections
- Business plan and investment thesis
- Contingent liabilities/ongoing and potential litigation

Recession Opportunities

- Employee equity grants can be given at attractive strike prices that present true incentives
- Estate planning opportunities exist for inter-vivos transfers at low valuations
- Time to reorganize for tax advantaged deal treatment
- Availability of executive and managerial talent

Recession Opportunities (cont'd)

- Creative opportunities for negotiation of interim measures with buyers, particularly strategics
- Elimination of weaker competitors
- Acquisition opportunities of competitors, particularly distressed companies

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Conclusion

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