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CREATING A MARKETABLE BUSINESS

By Enrique C. Brito, CFA, AVA, CM&A

Most business ventures get started by entrepreneurs who are capitalizing on their experience, skills and contacts. Typically, for the first few years the owner is the main engine behind the growth of the business with delegation being exercised grudgingly and sporadically. Consequently, as the business grows and succeeds in the marketplace, it becomes more and more difficult to separate the business from the owner.

The previous sequence of events is fairly common in service business. However, while the business may be very successful in its own right, it may not be worth much in terms of market value. This is because the knowledge, processes and skills are the owner's and as a result it is nearly impossible to transfer them without a management transition period that is likely to take several years.

Many people start consulting practices as solo practitioners, and while many remain that way, others bring in additional resources as the business grows. If the entrepreneur's objective is to create a personally satisfying job that makes use of his/her talents, experience and skills, then developing a solo practice may enable them to fulfill that goal. If however, the objective is to build a marketable business that can be sold in a few years, a different strategy will be needed.

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EXPERT TIPS

CAN EARNOUTS REALLY CLOSE THE GAP?

In mergers and acquisitions, an earnout is a mechanism to bridge a value gap between the parties involved in a transaction. As such, they can take two forms: confirmatory (to make sure that what has been represented actually happens) and incentive (to create incentives for shareholders and managers). At first glance, an earnout may seem as a logical choice, since they help bridge valuation gaps, retain key managers and provide incentives for management to achieve aggressive performance goals. However, more often than not earnouts are difficult to implement and quite often result in litigation. On one hand, issues associated with operating control may prevent one of the parties from achieving the stated goals. Also, agreeing on earnout formulas that are unambiguous and easy to measure can be a challenge. Therefore, given the implementation difficulties of earnouts, buyers and sellers should resist the temptation to prematurely stop the negotiation process and exhaust all available options to close a perceived gap in the deal's value before agreeing to an earnout. ■

TRENDS TO ACT ON

PRIVATE EQUITY HEATS UP

The most recent (Q2 2006) Venture Capital Report from the Mid-Atlantic Venture Association shows that valuations across most industries continue to increase and that term sheet competition from private equity groups is rising. The report also shows that private equity firms are currently focusing on a selected group of areas where they see the greatest opportunities in the next few quarters, namely, new media, biotech, telecom (new), security, government-developed technologies, and education technologies. Another important finding is that venture firms continue to maintain the same essential requirements for investment as one year ago. Although their relative ranking tends to vary slightly from quarter to quarter, basically the same criteria continue to show among the top five: quality of management team (71%), valuation not aligned with expectations (55%), market potential (48%), value proposition (36%) and revenue (33%). ■

M&A TRENDS

THOUGHTS ON M&A FROM THE CORPORATE SUITE

Increased competitive pressures continue to force companies to focus on their core assets and to look for growth opportunities overseas. A recent KPMG survey of 138 senior executives who were questioned about their thoughts on M&A showed the following:

Survey Results

- Increased focus on cross-border M&A with 2/3's expecting at least one international deal in 2006, up from 1/2 in 2005. While big companies have always done cross border deals, mid-market companies and private equity groups are now more active overseas.
- The usual drivers for M&A continues in that corporate management is increasingly focusing on core assets and wants to shed none-core businesses... then redefine their core business.
- Specific enhancements for M&A include: 1) access to new customers; 2) increasing the scale of the business; and 3) gaining new markets.
- The survey also indicated the biggest problems for M&A including the hidden or unrecorded liabilities post-closing, and the incomplete planning prior to transaction closing.

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ABOUT THE MCLEAN GROUP

The McLean Group is a middle-market investment bank providing merger and acquisition, business valuation, capital formation, executive advisory and litigation support services. Its focus is on serving middle-market businesses generating between \$5 million and \$300 million in revenues. The firm has a widespread practice with particular expertise in the IT services, technology, telecommunications, government contracting, staffing, and travel and hospitality sectors. Registered broker dealer.

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CREATING A MARKETABLE

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In essence, the value of a business for a prospective buyer resides on the potential for the business to generate enough cash flows (revenues less operating expenses) to enable the buyer to recuperate the original investment and realize (and probably exceed) a given rate of return. Of course, the business' past performance will provide the buyer with anecdotal evidence about the enterprise's potential to generate the earnings necessary to meet the buyer's objectives. However, the risk for the buyer resides on whether or not that past performance can be repeated and even surpassed in the future.

Having a business that is too dependent on its owner is certainly one of the main factors affecting its marketability. However, this is not the only factor as there are other issues that will also have an impact on the potential marketability of a business such as:

- An inexperienced management team
- High customer concentration (having just a few large customers)
- Poorly maintained financial records
- Poorly maintained assets
- Contingent liabilities
- The threat of litigation

In the end, the acid test for an owner who wants to find out how marketable the business is, revolves around the answer to a simple question: Can I afford to leave the business for a couple of months without any significant deterioration in its performance? The answer to this question not only can be quite revealing, but also it can point out to the need for a change in his/her leadership strategy. ■

About the Author: Enrique C. Brito, MBA, CFA, AVA, CM&A is a managing director of The Mclean Group, a private investment bank providing merger and acquisition, valuation and private equity financing services. He has over 17 years of corporate finance and investment banking experience and lectures nationally on the subjects of business valuation and M&A.