

INSIDE THIS ISSUE:

<b>Featured Article:</b> <i>So, You Want To Sell Your Company To A Private Equity Group?</i>	1 & 2
<b>Expert Tips:</b> <i>Transaction Price vs. Value</i>	1
<b>Trends To Act On:</b> <i>Will the Demand for Ethanol Drive up Corn and Food Prices?</i>	3
<b>Exit Planning:</b> <i>Buy-Sell Agreements</i>	3

## So, You Want to Sell Your Company to a Private Equity Group?

By Neil Paschall

You've heard about it from your friends and colleagues, you hear it at your club, you read about it in the newspaper and on the Internet, and hear about it in the television news. Today's market is hot and Private Equity Groups (PEGs) have too much money chasing too few deals resulting in historically high multiples. You know that timing is not everything, and never will be everything, but sometimes timing is so important that nothing else matters. Is now the time to sell your company to a PEG and take advantage of the high multiples?

There is no doubt that today's market is hot. PEGs have \$800 billion in investment capital that can be leveraged, according to a recent Business Week article, and investment capital continues to pour into the sector at a rate of \$175 billion in 2005 and more than \$200 billion in 2006. PEGs have acquired Dunkin' Donuts, Hertz, Burlington Coat Factory, Clear Channel Communications, Readers Digest, Eddie Bauer, Burger King, Dominos Pizza, AMC Entertainment, Equity Office Properties, Rite Aid, Harrah's, Station Casinos and Neiman Marcus among many others. PEGs have paid extraordinary multiples for some of these companies. PEGs are not just looking to acquire household names: almost all industry sectors are of interest, provided that the target company has a track record of making a sustainable profit or is perceived to have that potential. So, whether your company is an old-line firm, a growth business, or a participant in a consolidating industry, there may well be a PEG buyer out there for you. But, if you are a candidate for a PEG acquisition:

*(article continued on page 2)*

## EXPERT TIPS

### Transaction Price vs. Value

Like most things in life, beauty is in the eye of the beholder. When it comes to buying a business, value is in the eye of the buyer. The primary determinant of what a buyer will be willing to pay for a business is the future cash flow that the buyer expects to realize from the business. This anticipated cash flow not only determines the rate of return the buyer will achieve, but also how much debt can be used to purchase the business. Until a sale is negotiated, the true fair market value of the business will not be known. In fact, the actual sale price will fall somewhere between what the seller thinks the cash flow of the business is worth (as is) and what the buyer is willing to pay for the future cash flow that the business will generate.

From the seller's point of view, determining the value of the cash flow of a business (as it currently stands) is done through several valuation methods that consider historical earnings (cash flow) and apply a capitalization rate or market multiple to calculate an indication of value. However, although these methods are acceptable for general planning purposes, they don't take into account a variety of other factors that will influence how much a buyer would be willing to pay for the business.

From the buyer's perspective, the perception of value will be influenced by a number of issues including: (a) the buyer's expectation of the future performance of the business, (b) expected synergies (operational and financial), (c) cost of borrowing money, (d) expected return compared to other investment alternatives and (e) current conditions of the M&A market among others.

Therefore, it is very important that sellers establish financial objectives before they begin the sale process. It is no less important that sellers assess the price they are likely to receive from the sale by considering the transaction from the buyer's perspective.

## So, You Want to Sell Your Company to a Private Equity Group? [continued]

Questions for those considering a private equity buyout:

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- How do you navigate through this maze of activity and players?
  - How are private equity firms structured, and what motivates them?
  - How do you identify a private equity firm that would be a good buyer?
  - Who should be on your advisory team?
  - How do you evaluate your alternatives and manage the process to prevent it from spinning out of control and potentially damaging established relationships with employees, customers, suppliers and financial partners?
  - What are some of the key deal terms you should anticipate?
  - When is the right time to sell?
  - Should you sell the entire business for cash or engage in a structured alternative?
  - Are you really prepared to lose control of the business you have put everything into building?
  - What are some of the traps for the unwary?
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In short, how much of the PEG hype you hear at cocktail parties or your club actually applies to your company and situation?

In a series of three articles, I briefly will explain PEGs and their increasing presence in the merger & acquisition arena and address many of the issues sellers face when dealing with PEGs as well as the minefields that are present but too often invisible to the unwary. In this first article, I will discuss how PEGs are structured and what motivates them.

PEGs are usually structured as limited partnerships. The limited partners are institutional investors, such as pension funds and insurance companies. The general partner is a limited liability company or other entity in which the private equity investment professionals are members.

The general partner usually receives a periodic management fee based on a percentage of funds committed (often 2.0% per year) and a share of the profits. A typical arrangement today: after the limited partners get their investment back plus stipulated returns of say 8.0%, remaining profits are split with 80% going to the limited partners and 20% going to the general partner. The general partner's profit ("carried interest") is then split among the private equity investment professionals.

PEGs are motivated by the desire to acquire companies, improve their operating performance and then sell them back into the marketplace, working better than they did and thereby justifying a higher sale price than was paid upon purchase. However, PEGs are limited in the amount of time available to complete these transactions. PEGs have limitations on the periods during which they can deploy the investment capital (usually 7 years) and limitations on the length of time the limited partnership may exist (usually around 10 years). As a result, the expected time available to manage a specific portfolio company ranges from three to seven years after which time the PEG begins looking for an exit through either a sale to another PEG, sale to a strategic investor or a public offering.

With the huge amounts of money that have poured into PEGs, competition for deals has driven deal prices up and return expectations down. In today's seller-favorable market, PEGs are under great pressure to make investments and to dispose of them promptly. Often, there are several firms competing for the same deal, so a PEG, in turn, may be looking at several potential transactions, realizing that it cannot consummate all the deals it is pursuing seriously. The essence of the process for the PEG is to optimize flexibility and optionality while still "locking up" the seller. Accordingly, it is not unusual for a seller who has been told he or she will get his or her price, to enter into a letter of intent with an exclusivity provision only to find that, as a result of the due diligence, the PEG wants to renegotiate the price or other terms, or is unwilling to proceed in any event.

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## TRENDS TO ACT ON

### Will the Demand for Ethanol Drive up Corn and Food Prices?

The production of fuel ethanol in the United States has created a strong demand for corn. In fact, in the 2006/07 marketing year, more than 2 billion bushels – or 20% of the 2006 crop – is being used for ethanol production. This amount is nearly twice the amount used for ethanol in 2002/03. In response to the rapidly escalating demand for ethanol, both corn futures and corn prices have increased from \$2 per bushel in January 2006 to \$4 per bushel in February 2007. So the question in everybody's mind is, will this steep increase in the price of corn have an impact on retail food prices?

According to a 2007 study commissioned by the National Corn Growers Association (NCGA) the answer is a resounding "no." The study shows that if current corn prices are sustained in the \$3.50 to \$4.00 per bushel range, consumers could experience a minor 2% to 3% increase in the food prices of 2007. To further put the issue in perspective, the typical American household today spends just 6.5% of its income on food (including beverages). Accordingly, if marginal increases in food prices do materialize during the next several years, the impact on total household spending is likely to be negligible.



## EXIT PLANNING

### Buy-Sell Agreements

A buy-sell agreement controls the transfer of ownership in a business when certain events occur. As such, it is probably the single most important document that the owners will execute. Events that trigger a buy-sell agreement vary widely: the death of an owner, disability, termination of employment, retirement, bankruptcy, divorce and a business dispute among owners. Under any of these scenarios, the buy-sell agreement may require (or give the option to) the business or the remaining owners to purchase the departing owner's stock. The agreement also should establish the value of the stock and set the terms and conditions of the buyout.

Buy-sell agreements have advantages as well as disadvantages. Advantages include: ownership in the business can only be transferred in accordance with the agreement, valuation is set for the sale and tax purposes, terms and conditions are fixed, and rights among shareholders are protected when they would not be otherwise. Among the disadvantages: legal fees must be incurred, a complete document is difficult to achieve (it is virtually impossible to anticipate every contingency), and periodic revisions are needed given the long-term nature of the document.

For more information on exit planning visit The McLean Group Exit Strategies Institute [[www.planyourexit.org](http://www.planyourexit.org)]