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The McLean Group is a national investment bank serving middle market businesses. For more information, visit www.mcleanllc.com.

Feature Article:

Focused Due Diligence—The Key to Successful M&A Transactions

By Bruce Thomas, M&A Analyst, McLean, VA

Mergers and acquisitions are on the rise in 2010 after several years of transaction declines due to the great recession. With the multitude of challenges facing companies today, due diligence is more important than ever to ensure that a transaction benefits all parties involved. Studies have shown that about 70% of all mergers and acquisitions fail to create meaningful shareholder value. Because a deal's success is usually based on shareholder value, it is essential that the buyer conduct due diligence with particular focus, seizing the opportunity to confirm all seller-provided company information before closing the deal.

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Expert's Corner:

Preparing a Middle Market Business for Sale

By Dennis Roberts, Principal, McLean, VA

Business owners should get in the habit of regularly measuring their companies' value—even when they have no intention of selling in the immediate future. Thorough, periodic valuations provide useful status reports highlighting value drivers and areas in which their companies' performance needs improvement. This allows owners to establish strategic and tactical plans to grow their companies into highly saleable businesses in time for their eventual sale.

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Confirmatory due diligence, Purchase Agreement negotiations, and deal closing generally transpire within the final 60 days of the transaction cycle. It is during this period that all team members must collaborate to ensure the deal is closed smoothly and in the buyer’s and seller’s best interests. Confirmatory due diligence generally falls into three categories: financial, legal and operational.

The buyer and the buyer’s accountants conduct financial due diligence to review and confirm all seller-provided information addressing the company’s financial performance before closing the deal. Meanwhile, the buyer’s legal team conducts legal due diligence by reviewing the seller’s contracts and agreements with customers, suppliers, employees, sub-contractors, and taxing and licensing authorities. Operational due diligence entails reviewing the seller’s technologies, assets, and back-office business systems and may include meetings with management and often key customers.

Upon completion of confirmatory due diligence, the drafting and negotiating of the final, binding Purchase Agreement begins.

It is important that the seller anticipate everything a potential buyer may request during due diligence. For example, it is imperative that the seller has audited financial statements, or at the very least, reviewed financial statements for the prior three to five years. Audited financials are particularly important because at this stage in the transaction cycle – after a Letter of Intent has been delivered – the discovery of material errors in the seller’s financial statements is likely to derail a closing or precipitate significant changes in final terms.

Throughout the transaction cycle, the seller should work closely with his or her investment banker to gather and organize the documents required for confirmatory due diligence rather than launching the process upon receipt of a Letter of Intent. It

has been said that “time kills all deals,” so every effort to expedite the process improves the odds of closing a transaction. All documents required for confirmatory due diligence should be available for review immediately upon execution of a Letter of Intent. This minimizes the risks posed by external (or internal) events that could disrupt or derail a closing. Organized, accurate due diligence documents enable the buyer’s team to proceed with increasing confidence through the process to closing while poorly-organized documents that appear inaccurate or contradictory likely will complicate or even terminate the due diligence process far short of a closing. The seller’s mantra during the confirmatory due diligence process – and that of his or her advisors – should be: “No Surprises.” This requires thorough preparation of all appropriate confirmatory due diligence materials by the seller.

Technology has introduced the virtual due diligence data room, where documents can be uploaded securely via the Web and accessed remotely 24/7/365 by all parties involved as principals or advisers in a transaction. Virtual due diligence data rooms constitute a welcome change from physical due diligence rooms – oftentimes one or more conference rooms provided onsite by the seller, or an advisor to the seller – through which teams of bankers, lawyers and accountants shuffled in and out, as inconspicuously as possible, during allotted time periods. Organizing, copying, shipping and distributing paper-based documents in support of the confirmatory due diligence wastes valuable time (and money) while the sheer volume of documents can make management of brick-and-mortar due diligence materials highly impractical. Virtual due diligence data rooms significantly have increased the efficiency of the confirmatory due diligence process while also dramatically reducing the time required to prepare and launch the data room itself.

Accountability, verifiability, integrity and internal controls are all critical in this post-Sarbanes-

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Oxley (SOX), post-Madoff era. Mergers and acquisitions executives are prepared to invest more time and money to carry out extensive “hands on” confirmatory due diligence rather than merely relying on such post-closing deal terms as hold-back escrows, earnouts and closing balance sheet adjustments. Data rooms enable the seller to prepare and gather all required due diligence documents and information. However, caution is advised because there is no substitute for face-to-face discussions with management teams. In all, focused due diligence is the key to a successful M&A transaction. ♦



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A business valuation’s thorough analysis can enable owners to manage their companies to perform optimally against a series of metrics. For example, has the company established:

- A highly-experienced management team that is not overly dependent on a single manager or owner
- Steady revenue and profit growth rates
- Product and/or service excellence that makes the company a leader in its business sector
- Barriers to entry that discourage competitors, and
- A broad client base that minimizes over reliance on one or more of the company’s top customers?

Implementing these metrics or value drivers likely will increase the company’s ongoing profits while steadily building the company’s value. This can be particularly important in the event of a sudden urgency to sell that may arise from an unsolicited offer to buy the company or a death among the company’s principals. Such external or unanticipated

circumstances obviously are not ideal selling triggers because they dramatically rush preparations for sale. Companies that need to sell quickly that have not obtained a valuation analysis – and used it to implement operational improvements – likely will realize less than optimal purchase prices. Therefore, preliminary valuations serve as precautionary tools preparing companies for unforeseen, abrupt, “fire drill” sales.

Preferably, owners should begin planning their exit strategies one to four years in advance to allow ample time to grow their companies’ investment values. In addition to identifying value drivers and developing their businesses based on those drivers, middle market entrepreneurs also may undertake a number of presale initiatives that should substantially enhance their businesses’ salability. Such initiatives include:

- Hiring a CPA to “clean up” the business’ accounting and tax records (deals frequently fail or experience major value adjustments when incomplete or inappropriate applications of accounting principles are discovered)

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- Establishing an effective management team (buyers are more likely to pay a premium for a business if they are confident the acquired company’s managers will remain with the merged company to successfully execute the post-acquisition transition, minimizing the risks that arise from wholesale management replacement)
- Committing the management team to stay with the company after the sale (and where appropriate) by a reward system as soon as possible
- Clarifying major contractual relationships with customers, suppliers, landlords, etc.
- Registering and protecting trademarks, patents and copyrights
- Seeking favorable media coverage for the business, products, services and personnel (a sufficiently large company may want to consider hiring a PR firm)
- Reviewing and ensuring compliance with Occupational Safety and Health (OSHA) policies
- Reviewing (and addressing) any hazardous waste issues
- Ensuring all licenses, permits and tax registrations are in order (the buyer may want a legal opinion), and
- Cleaning and organizing the shop, office and plant (a little beautification suggests a level of professionalism and attention to detail that may not be considered a key value driver but likely will enhance a business’ investment value by subtly impressing potential buyers).

Even though a company may have diligently allotted a liberal amount of time to prepare for sale, many unexpected issues can arise to hinder or halt negotiations, including:

- Changes in the macro economy

- Force-majeure events like 9/11
- Changes in the outlook of the company’s industry
- One or more sales of similar companies at unexpectedly low prices, and
- Sudden negative changes in the business’ financial and/or operational performance, etc.

Therefore, in addition to obtaining a preliminary valuation, identifying positive and negative value drivers used to reengineer the business to optimize value, and rationalizing and smoothing ongoing operations, owners should prepare mentally for the possibility that the transaction might not close. To best do this, owners should approach the sale as if it may not happen and maintain business operations as if the company were a going concern. Buyers prefer this seller mentality as it provides the greatest assurance (and likelihood) that the business will continue to run smoothly with little or no disruptions post-acquisition.

Note that managerial decisions that sellers make solely in the interest of an immediate sale of a company tend to prove counterproductive in the long run and may yield materially damaging results if the business is not sold. There is a subtle and challenging balance that owners must maintain between focusing on selling a business and making necessary decisions to run the business day-to-day. However, owners should avoid, whenever possible, new long-term commitments, major changes in business operations, or actions that may result in litigation. But many longer-term decisions that do not immediately produce cash flows (or may even decrease them) can be normalized or rationalized from current operations by restating financial statements so as to affect transaction value only minimally, if at all. ♦

Our Locations:

Washington, DC*	703-827-0200
Anchorage, AK	907-277-3725
Asheville, NC	828-606-1101
Atlanta, GA	678-461-0775
Austin, TX	512-687-3485
Baltimore, MD	410-799-2053
Boston, MA	978-475-2511
Bozeman, MT	406-586-9746
Buffalo, NY	716-489-2048
Chicago, IL	312-994-2550
Cleveland, OH	440-484-1060
Columbia, MD	410-440-3189
Dallas, TX	214-705-9724
Erie, PA	814-397-7737
Halifax, Nova Scotia	902-832-2774
Hartford, CT	860-255-0107
Hattiesburg, MS	601-671-4098
Lafayette, LA	337-365-3979
Miami, FL	305-804-6181
Milwaukee, WI	262-646-6490
Phoenix, AZ	602-549-9946
Reno, NV	775-825-7637
Sacramento, CA	916-929-0900
San Francisco, CA	510-444-6195
Silicon Valley, CA	650-638-2310
St. Louis, MO	314-307-1090
Tulsa, OK	918-492-3388
Tallahassee, FL	904-219-5750
Tampa, FL	559-289-7878

* headquarters office

About The McLean Group

The McLean Group is a national, middle market investment bank providing mergers & acquisitions (M&A), capital formation, market intelligence, business valuation, litigation support and exit planning services. Headquartered in Northern Virginia's technology, communications and government contracting corridor, the firm is among the largest independent middle market investment banks in the Washington, DC area. The McLean Group is a FINRA Registered Broker/Dealer and Member FINRA/SIPC.

- **M&A:** The McLean Group uses its considerable expertise in a wide variety of industries to identify the most probable and suitable candidates to complete transactions under the most favorable terms for its clients.
- **Capital Formation:** The McLean Group arranges private equity, venture capital, senior debt and subordinated debt in amounts ranging from \$5 million to \$250 million to support clients' expansions, mergers & acquisitions (M&A), refinancings, recapitalizations, leveraged buyouts and shareholder liquidity objectives.
- **Market Intelligence:** By leveraging superior competitive analyses, the firm provides business executives with comprehensive market intelligence reports, which provide the market insight and analytical expertise required to reduce risk and uncertainty in strategic decision making.
- **Business Valuation:** As a core competency and complement to its M&A business, The McLean Group provides business valuation services, including intangible asset and financial security valuations for a variety of transactions, financial reporting and tax purposes.
- **Litigation Support:** From quantifying economic damages to valuing a minority interest in a business, the firm has the business valuation experience and credentials to support cases involving a variety of legal issues.
- **Exit Planning Services:** Based on its extensive experience advising owners of middle market businesses, The McLean Group has developed a proprietary process that analyzes more than 60 value/risk drivers that can have a significant impact on the value of a business.

