

M&A

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The McLean Group is a national, middle market investment bank serving businesses generating up to \$500 million in annual revenue. For more information, visit www.mcleanllc.com.

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Dennis Roberts' book, *Mergers & Acquisitions: An Insider's Guide to The Purchase and Sale of Middle Market Business Interests* is still available at Amazon.com.



Feature Article:

Understanding the Balance Sheet in Middle Market M&A Transactions

By Brian Sullivan, Managing Director

Analyzing the balance sheet as part of the sale of many middle market businesses oftentimes can be a costly afterthought when uninformed buyers and sellers fail to give it the consideration it deserves.

Valuations are based on multiples of earnings that assume a cash free and long-term debt free balance sheet. Implicit in the definition is the assumption that the buyer has the right to receive the ordinary and necessary balance sheet required to support the business' earning capacity.

There are three important balance sheet dates that must be considered when negotiating price: 1) the balance sheet upon which the agreed upon targets are based; 2) the apparent balance sheet actually received at closing, and 3) the true-up or corrected closing date balance sheet usually determined within 30 to 60 days after settlement.

Long-term debt can either be assumed by the buyer or extinguished at closing on behalf of the seller. Sometimes short term revolving debt is disguised equity and thus requires careful analysis to establish the ongoing required working capital. Debt represents management's choice to use other people's money to fund growth. It can vary significantly among companies within an industry. Thus, an industry understanding of management philosophy towards debt as a financing tool is critical to ultimately establish a final negotiated sales price.

Several approaches are used to establish a reasonable estimate of working capital (current assets excluding cash less current liabilities). Typically, some sort of historical target company average is compared to industry levels to establish a fair estimate. In a high growth target, there may be

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a need for additional working capital to fund future growth and that obligation should fall on the shoulders of the buyer and not be unduly charged to the seller.

After close, there is normally a period of 45 to 60 days when the actual balance sheet is delivered and compared to the negotiated targets (true-up) discussed above. Differences between the actual balance sheet amounts and targeted levels of cash, working capital and debt are identified and the price paid to the seller is adjusted. Disputes can be costly and time consuming to settle, so it is worth the effort for buyer and seller alike to carefully consider the impact of post-closing balance sheet adjustments to the purchase price.

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Trends To Act On: *M&A Trends Expected into 2010*

By Mike Baca , Intern

From a macro perspective, M&A statistics suggest a significant decline in completed transactions when comparing the second quarter of 2009 to 2008 and even greater as compared to 2007.

However, good middle market deals continue to move forward with financial backing from private equity sponsors and even banks, while lenders focused on very large deals are taking a much more cautious approach to funding.

What trends should Sellers and Acquirers alike be cognizant of as they contemplate entering into a transaction? First, today's tight credit markets are forcing deal sponsors and acquirers to invest more equity with less financing per transaction. Target valuations and expectations must be adjusted and enterprise values have declined by 10% – 20 % when calculated based on purchase price/adjusted EBITDA multiples. Consequently, deal and negotiating leverage has tilted in favor of Buyers. Additional trends likely will persist through 2010:

- Due diligence processes will take longer and involve greater scrutiny to better understand operating, financial and economic trends affecting the target.
- Cash/stock will increase as a percentage of purchase price consideration versus debt financing.
- To bridge the gap between Seller valuation expectations and the amount of leverage Buyers can bring to the closing table (due to tighter leverage ratios, reduced cash flow lending, etc.) transactions will require increased purchase price earn-outs, Seller take-back financing and/or retained equity positions.

In conclusion, given today's economic realities, consummation of M&A transactions will require creative thinking to properly structure deals that work for the Buyer, Financiers, and Sellers alike. Under these circumstances, very strong opportunities should remain for middle market deals if considering the above trends.

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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. The McLean Group serves businesses generating up to \$500 million in annual revenues. 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.

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