

INSIDE THIS ISSUE:

Featured Article: <i>So, You Want To Sell Your Company To A Private Equity Group?</i>	1 & 2
Expert Tips: <i>Business Preparation in an Up Market</i>	1
Trends To Act On: <i>Will the Demand for Ethanol Drive up Corn and Food Prices?</i>	3
Exit Planning: <i>Buy-Sell Agreements</i>	3

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

By Neil Paschall

This is the second of three articles on dealing with Private Equity Groups (PEGs) as a seller of a private company. In the first article we discussed PEGs' enormous presence in the M&A market, how PEGs are organized and the principal motivations driving PEGs to do deals. In this article I will discuss how to prepare your company, how to manage the sell-side process, and how to position yourself to obtain maximum value. In the final article, we will discuss some key deal points and some general rules of the game in dealing with PEGs.

Let's start with the obvious: Private Equity Groups are highly professional at buying and selling businesses, they leave nothing to chance, and very little that will occur is accidental on the part of PEGs. As a seller you are required to be coordinated, attentive, nimble, and several steps ahead in your thinking. The benefits to you and your company of careful planning and sound management cannot be overestimated and almost always leads to a higher price, a more certain outcome, and more favorable timing.

The first step in the process, often overlooked or underestimated, is to know what you want to achieve. Defining objectives is critical; while you need to reserve the right to change your mind along the way, it is well worth the effort up front to try to determine what is actually going on in your head. Selling to a PEG means losing control of the business you have

(article continued on page 2)

EXPERT TIPS

Business Preparation in an Up Market

In any market, up or down, there are other issues that will affect value and most do not have a correlation to the market.

Remember that there are life-cycles to a business and selling one when its trends are positive and projections are rosy will have more impact than the conditions of the market. Here are a couple of tips to consider:

The value that the owners individually contribute may be a big factor to a business' perceived worth. Can that value be transferred in a sale? If the answer is no, the business may not be marketable in its current form. Make yourself expendable. The business should have a life of its own so that it can profitably function beyond the owner's daily purview.

Plan your exit. Selling a business is a process, not an event. The process is strategic; it is multi-faceted and starts with a comprehensive review of your company's operations, market, industry, competition, and other matters that a buyer will review when considering an acquisition. Start early. Understand what the value drivers are for your industry. Get a valuation. Know what areas in your business could be obstacles or detractors in a sale and where possible, make efforts to eliminate or minimize their impact.

Also, know that prospective buyers may have the edge as they often assemble sophisticated deal teams and they often have the experience of doing several deals. To level the playing field, enlist the help of those who are professionally qualified to assist you. Assemble an appropriate deal team whose members have transaction experience.

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

poured a good portion of your life into building. Even if you retain a management role post-acquisition, you are no longer in control of the company and you need to consider that before embarking on the process.

Aside from the inherent value of the business, nothing is more important to obtaining a successful outcome than defining, structuring, orchestrating, adapting, and controlling the process. It is like conducting research under the scientific method in that managing the process prevents it from spinning out of control and potentially damaging relationships with employees, customers, suppliers, and financial partners. And, of course, managing the process is critical to adding value and obtaining the maximum value the market will bear.

Many companies considering a sale will hire an investment banker to quarterback the deal team and to manage the process. The deal team should consist of management and professional advisors with merger and acquisition experience. This is no time for accountants and lawyers to gain on the job experience as every move will count and the PEG's deal team will be looking for any advantage to preserve its options while trying to lock-down the seller.

Once the deal team is in place the process begins with a critical look at the business performing the seller's own due-diligence on the business from the eye of a prospective purchaser. If there are issues with accounting procedures, controversial methods of valuing assets or liabilities, important contingent liability questions, key changes in the market, concerns about major customers or suppliers, material litigation or investigations, a pending change in law that will likely affect your business, dissident shareholders, or other matters that would affect your view if you were buying the company, the issues need to be identified and addressed. The time to tell the PEGs what they will find is early in the process while there is still competition seeking to purchase the company.

Once this internal review is complete and the investment banker has completed his own due-diligence, the investment banker will prepare a preliminary valuation, a blind profile, and a confidential information memorandum (CIM). The preliminary valuation reflects a range of value that the investment bank believes will be obtainable in the M&A market. It is provided only as a general guideline with management and is not disclosed to third parties. The blind profile is a summary of the business opportunity that will be distributed to potential acquirers as a solicitation of interest. It is designed to provide enough information about the business opportunity to enable a PEG to determine its level of interest without disclosing any confidential information about the selling company. In a recent transaction I was able to screen PEGs by their investment criteria, and contact over 500 PEGs whose investment criteria matched the opportunity within a week of completing due-diligence.

The investment bank will follow up on the initial contact and identify those PEGs that want to see additional information. Those PEGs will sign Non-Disclosure Agreements and copies of the CIM will be provided for their review. The CIM provides detailed information about the selling company and the business opportunity and is designed to provide each interested PEG with enough information to enable the preparation of an offer to purchase, or a Letter of Intent.

This is where the process gets interesting! This is the time results of creating value by positioning the company properly and by marketing and developing interested investor PEGs is realized, allowing the investment banker to conduct a negotiated auction among the PEGs. This is where controlling the process pays off. This is where the market value (the amount someone will pay) of the business is determined. As the investment banker is orchestrating the auction, management is continually advised of the progress and finally, on the advice of the investment banker, the seller selects the successful bidder.

The successful bidder is provided time to conduct its own due-diligence and if the seller and the investment banker have orchestrated the process properly, there will be no negative surprises. Then the process moves forward toward negotiation and closure, the subject of the next and final article.

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TRENDS TO ACT ON

M&A Market Remains Strong

According to Thomson Financial, May was a record month for the U.S. private equity market as \$115.5 billion in private equity deals were announced. This was a 125% increase over May 2006. For the first five months of 2007, \$315 billion in private equity deals were announced which is three times the amount in the first five months of 2006. Already in 2007, four private equity deals exceed the former record amount of \$25 billion Kohlberg Kravis Roberts paid to buy out RJR Nabisco in 1988.

Although the median pre-money valuation for U.S. venture-backed companies decreased from \$20 million in the fourth quarter of 2006 to \$18.5 million in the first quarter of 2007, it increased 13% on a year-over-year basis according to VentureOne. The median pre-money valuation for later venture rounds represented the largest increase among all venture rounds increasing from \$36 million in the first quarter of 2006 to \$41 million in the first quarter of 2007. The median pre-money valuation for later rounds in the first quarter of 2007 was the highest since the second quarter of 2001.

EXIT PLANNING

Transferring the Business to Your Heirs

There are a number of surveys which show that although two-thirds of business owners wish to transfer the business to their family members, less than one third actually accomplish this objective. There are various reasons for this including the impact of taxes, the ability and commitment of the children to run the business, and intervening family issues among others. Nevertheless, the real reason why business owners fail to transfer the business to their children is that they are not clear on how to approach the process of transitioning the business.

If you are planning on transferring the business to your heirs, there are number of issues you should carefully consider, among them:

- Will this type of exit strategy create conflicts within the business or my family?
- Will I be financially secure after transferring control?
- Can the transfer be implemented in a way that is tax efficient?
- How long should I remain involved with the business to ensure a smooth transition?
- Are family members interested in taking charge?
- Can I effectively transfer my experience and skills to the next generation?

Transferring the business to your heirs can be a positive and rewarding process for all the parties involved, if managed correctly. The secret is structuring a comprehensive plan that addresses issues related to taxation and financial security, as well as taking into account non-monetary aspects such as the transitional period for the management of the business, a developmental program for the new owner, and the careful definition of the appropriate roles for the family members involved.

For more information on exit planning visit The Exit Strategies Institute [www.planyourexit.org]