

## **Role of Advisers**

- Accounting
- Legal Counsel
- Investment Bankers
- Role of external industry consultants

While it may seem self-serving from the CEO of an investment banking firm, key advisers do provide immeasurable value to the shareholders of the **SME** ("*Small to Medium Sized Enterprise*").

## **Accounting and Tax Advisers**

The SME's accounting firm plays an integral and obvious role in providing an independent review of the firm's financial performance. Annual audited statements are the cornerstone of these independent assessments. Audited statements enhance the SME's value by minimizing risk to the acquirer /investor. Owners need to understand how to prepare their business for an investor. Reviewed statements at the very least should be provided on an annual basis.

The independent accountants generally do not provide an assessment or comment on shareholder expenses that are not truly business related that are run through their companies. It's therefore critical for business owners to keep a historical track of these expenses so that these "addbacks" can reformulate the true financial performance of the company.

Another key element of the accountant's support, however, is to assess the tax consequences of the strategic alternatives that the shareholders are considering before embarking on the effort. Such an analysis is often not considered until a capital raise, sale, or acquisition is well underway, and having the results provided later can derail the process that is being undertaken. Shareholders who are seeking a liquidity event for instance, may find that after tax cash is insufficient to continue certain life styles. Knowledge of the tax consequences ahead of time will not dampen or kill the euphoria of competing a deal later.

Shareholders should perform a "cash in pocket" after tax analysis of the alternative they are considering. An example of such an analysis for a sale event should look at various valuation examples and determine the after tax cash flow under each scenario. This is not often an easy task, particularly when multiple shareholders have different stakes (voting / non-voting, common vs. preferred equity, etc.). If consensus is required to do

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## INVESTMENT BANKERS

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a transaction, its best to have all the shareholders on board, fully understanding the benefits and after tax cash proceeds they receive or not.

Since the tax costs of a stock vs asset deal structure are often different, the “cash in pocket” analysis should consider both. An example simplified template that the shareholder’s tax counsel should complete would be:

Company X											
Post-Closing, net after tax cash to shareholders											
Consideration											
Cash											
Seller note											
<b>Total Consideration</b>			10 million low			12 million probable			15 million high		
			Federal	California	Total	Federal	California	Total	Federal	California	Total
Asset Sale Structure Transaction											
Selling Price											
Closing costs (IB/legal)											
Net Selling Price											
Liabilities Assumed											
Total Selling Price											
Assets Sold											
Gain on Sale of Assets											
Basis of Assets											
Gain on Sale of Assets											
Long Term Capital Gain											
Taxes											
Cash in Pocket after taxes and debt repayment											
Stock Sale Structure Transaction											
Selling Price											
Closing costs (IB/legal)											
Net Selling Price											
Liabilities Assumed											
Total Selling Price											
Gain on Sale of stock											
Basis of stock											
Gain on Sale of stock											
Long Term Capital Gain											
Taxes											
Cash in Pocket after taxes and debt repayment											

Our firm has had some prospective investment banking engagements deferred when shareholders have done a careful analysis of this type. Why? There wasn’t enough cash after the transaction to satisfy the expectations or needs of the shareholders. This is an important exercise to perform in the consideration of strategic alternatives.

**Legal counsel**

The role of astute, deal-oriented and experienced lawyers is obvious. Unfortunately, business owners sometimes rely on transaction advice from legal advisers that don't have the experience in securities transactions. A trusted lawyer who has assisted the company for decades in its human relations management or is a generalist that has reviewed business contracts is probably not the right team member to know alternatives or negotiating points for reps and warranties, for example, of a M&A transaction.

The business owner would be well served to interview at least three M&A deal attorneys, the names of which can be provided by your tax counsel or your investment banker. Chemistry is important as well as the lawyer's ability to explain deal points in a transaction in layman terms. Most business owners sell their companies once and it's important to have counsel that appreciates this.

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### Investment Bankers

This author is a FINRA licensed / SEC audited broker/dealer<sup>1</sup> authorized to engage in investment banking and security transactions. It is imperative to engage an investment banker or at least a "business broker" as the financial intermediary representing the shareholders. If the SME owners are raising equity capital, selling the company or acquiring a company its best to engage an experienced financial adviser. Such action can be the most important event in the life of the business.

To the layman SME owner, an investment banker exists for the following reasons:

- When raising equity, maximize valuation of the client's company and minimize dilution to the existing shareholders.
- When engaged to sell a business, maximize valuation of the business for the benefit of the shareholders.
- When acquiring a company, minimize the effective cost to the acquirer.
- The investment banker accomplishes these functions by professionally managing a confidential marketing campaign and creating a *competitive market* for its client companies. The right professional can help navigate complexities of any financial transaction and negotiate on behalf of the client with the investor/acquirer/seller. Business brokers and for larger companies, investment bankers, are the advisers that will provide valuation advice, confidentially solicit buyers or investors, negotiate with them, and provide oversight on closing a transaction.
- The investment banker acts as the *intermediary* between the client and the other side and negotiates as an independent adviser between the parties. This role minimizes direct confrontation between the principals.

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Owners of SME companies engaging investment bankers should engage a FINRA member and check their credentials at FINRA's broker/check site: <https://brokercheck.finra.org/>

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Frequently, SME owners believe they can perform these functions by themselves, and certainly the larger companies with business development executives could have the requisite time and experience to do this. However, the work involved in these transactions is a full time endeavor requiring skill sets not found usually in the SME. The investment banker definitely earns their fees as attested to by owners giving positive testimony found on many investment banking websites.

Investment bankers will cite many instances where SME's are approached by single investors/acquirers directly, and owners become enamored by these overtures. What these owners fail to realize is that a single offer from such a source does not affirm the *market value* of the company (or investment or acquisition candidate). Only by confidentially canvassing the market will the real market value of the deal be known.

The investment banker knows, for example, that strategic investors / acquirers will generally, but not always, place a high value on the enterprise given that synergies exist between strategic partners that enhance value. Strategic valuations generally include a premium over what pure-play financial investors will offer.

These strategic investors can take longer to court and take longer to bring to the table for the investment opportunity. Only the larger companies will have M&A executives that are full-time seeking investment opportunities to enhance their companies. Smaller strategics without such resources need to be lead and it is often difficult to capture the attention of a strategic CEO. Investment bankers will time their solicitations to account for this.

The investment bankers will assist the SME client in developing proforma forecasts of the business and test the defensibility of the assumptions used in the forecast. These financial scenarios will be the basis of rendering an opinion of the range of valuations of the enterprise. Generally, the business acquirer will ask in their opening moments: "Where is this business going?"

Investors may want some of the SME shareholders to roll a portion of their equity lowering the investment risk for the investor while giving the shareholders a "second bite of the apple" when their rolled equity is sold later. The investment banker will evaluate these equity alternatives as part of their engagement to the shareholders.

Above all, all work done by the investment banker is done in a confidential environment with those with a need to know apprised of its work.

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**From our experience, the worst situation for a business owner is to focus on one investor/acquirer, perhaps one that is well known to the seller or someone who has made an initial "serious" inquiry to invest in or acquire the business owner's company.**

Anecdotes are many:

- A SME client insists that the single acquirer of her business is from a vendor that has known her and the company for 17 years. An acquisition offer was made by this party that was embarrassingly under market, and resulted in a hired i-banker fast tracking a marketing campaign that resulted in offers over twice the insider bid.
- A SME owner insisted that a "fair value" for his business be communicated to investors directly by his CFO internal adviser. The investment banker ultimately engaged to raise equity capital for the business (the internal effort failed) insisted that the valuation of the business will be determined by the market through negotiating with multiple investors and NOT broadcasted to the market. The lead deal was always in "second place" and was improved by the i-banker through negotiation.
- A SME's shareholders insisted on merging (selling) to a well known competitor, believing that the valuation would be superior to any other investor. Only after an insider offer was made was an investment banker engaged and a process was fast tracked to explore other investors. The result was that a private equity group was found with a platform investment in the SME's space, and a superior valuation was ultimately offered from that PEG.

### **Engaging the investment banker**

Whether for M&A or growth capital needs, the SME owner needs to consider and negotiate the engagement agreement with the i-bank. Elements to consider include:

- **Scope of the engagement:** specifies what the i-bank will do. Specific responsibilities are also noted and include, but not limited to the following examples:
  1. Determine an appropriate plan to raise \$x million or to sell up to 100% of the SME client and in the design and implementation of full aspects of the process to solicit, coordinate and evaluate proposals for any potential or actual Transactions;
  2. Prepare and disseminate a detailed Confidential Acquisition Memorandum ("Memorandum" or "CIM") to prospective acquirers/investors after receipt of a non-disclosure agreement. We shall identify, contact and qualify potential

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acquirers/investors, financing sources, or strategic partners and act as the SME client's representative in discussions with such parties

3. Assist and provide guidance to the SME client's management in preparing financial projections, in formulating forecasts and provide management advice with respect to valuation of the Company under various scenarios;
4. Assist in the negotiation and review of proposals in connection with, any potential or actual Transaction and assisting in all aspects of the negotiation process including establishment of structure, valuation and terms;
5. Assist in the financial and strategic analysis necessary to facilitate the proper and timely integration of the financial and tax aspects of any potential or actual Transaction;
6. Provide oversight of the due diligence process and as required, assist in the non-legal aspects of final documentation and closing;

The responsibilities of the client company are also specified. The client is responsible for providing company data in a timely manner that is factual and is to be relied upon. Also, any developments that occur at the client that can materially change the scope of the engagement needs to be disclosed.

- **Team:** who is on the client's team? Owner's need to be careful not to have junior bankers manage the process after hearing the pitch by senior I-bank management.
- **Fees:** Most engagements will specify a **retainer fee** paid up front to fund the costs of the engagement, preparation of the CIM, marketing, negotiating with investors, securing / negotiating the LOI and definitive documents, working with financial accounting and legal adviser on both sides, and providing oversight of the closing process. Should a transaction close, there is a success fee that is typically a percentage of the transaction value. In fund raising engagements, there will often be warrants given to the I-bank based on a % of the valuation and these can be monetized within a certain period of time after the initial closing. Success fees based on closing a transaction must be clear on how the consideration is defined. Often there will be cost reimbursements for travel, printing and extraordinary expenses.
- **Duration of the engagement:** The work is typically performed in a negotiated period of time. There will be a **tail provision** that specifies the payment of success fees if the client does a transaction post-termination of the I-bank contract.

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- **Indemnification:** this is a critical element of the engagement and requires the client to indemnify the I-bank for any and all claims arising out of the transaction. Governing law jurisdiction is also specified.
  - **Confidentiality:** All parties to the engagement agree that every aspect of the engagement will be kept strictly confidential.

### **Role of consultants**

In reviewing strategic alternatives for the SME, industry data and comparison to the SME is very important. The SME's financial adviser will probably prepare a **Confidential Information Memorandum** (CIM) that will ultimately be the cornerstone document for the investment community. The CIM will discuss the state of the market and industry in which the SME belongs. A necessary data set will be identifying the competitors and what is their performance and core competencies vis a vis the SME client.

Key sources of this data are available from industry consultants and from the trade associations that the SME is a member.

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