

Dealmaker

Providing business owners and managers with M&A market insight Vol. 4, No. 1 Winter 2008/09

Is private equity right for your family-owned business?

By **Stephen McGee**, executive director,
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Family-owned businesses and private equity: the two are hardly strangers. Over the years, there have been private equity investments — of all types and across a myriad of industries — in family-owned entities.

That said, thanks to retiring baby boomers, such investments might become a larger part of private equity portfolios in the coming years. Given the demographics of this large and entrepreneurial generation — 78 million Americans born between 1946 and 1964, according to the U.S. Census Bureau — we are just entering an era where increasing numbers of family business owners will be looking to partially or fully divest their ownership in firms they or a family member founded. In fact, a 2007 Grant Thornton International study found that four in 10 businesses will change hands in the coming decade.

For these reasons, more private equity firms may decide to explore investments in family-owned businesses.

These types of deals are often very personal and the transactions call for a nuance and finesse that might not be necessary in other types of dealmaking.

As an illustration, a Grant Thornton client, the founder and CEO of a successful manufacturing firm, recently decided the time was right to diversify his wealth. He wanted to realize some liquidity and pursue philanthropic and other interests. Although he was ready to relinquish majority ownership, he wanted to continue running the company, at least for several years.

As a business owner, and not a dealmaker, the client was unfamiliar with the finer points of a recapitalization and had many questions. To help allay his concerns and educate him on the finer points of private equity, a series of meetings was held with several private equity firms. Armed with a list of questions, the client quizzed each of the firms' representatives on its investment process, plans for running the company, the likely exit, and the history of the private equity firm itself. The marathon sessions, which took place over three days, illustrate the concerns central to family business owners looking to sell.



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Control

The idea of giving up control is not easy.

As the person at the helm, you want to leave a legacy for the business, your family and your employees. When meeting with private equity firms, align yourself with one that presents itself as a partner and the investment as a true collaboration designed to further grow the company and to benefit investor and owner alike. Some private equity firms, of course, insist on full control, while others are flexible. The key is to match the fund with your objectives.

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Clearly outlining the difference between economic and operational control is of paramount importance. There is often a misperception among owners that a private equity firm will constantly be looking over their shoulder, involved in every decision concerning the operation of the business. In most cases, however, the investor wants the person who has so successfully built and run the business day to day to continue doing so.

Leverage

Business owners fear it. Private equity firms can't do a deal without it.

Many business owners have never operated with leverage. The idea of placing significant debt on the business can be troubling. A primary concern is the possibility of default, and what it may mean for the business and you personally. Will the private equity firm show you the door, or use its influence with the lender to help remedy the situation?

Education here is all-important. While the downside may be obvious, having your advisor help you understand the necessity, benefit and significant future gains made possible by the use of leverage often times can help you get over the hump.

Deal structure and fees

A deal must be equitable to both sides.

In addition to leverage, there are certain elements of a deal structure that particularly resonate with owners and that need to be addressed up front and clearly explained. Private equity firms frequently prefer to use a different type of financial instrument than what a business owner will receive to guarantee downside protection. This could be a deal breaker.

Private equity firms should be willing to share in the same risks and rewards as you. If there are incentives for you to get a greater piece of the upside upon exit, such as a clawback, the private equity firm should ensure that you fully understand them.

Some transactions include a closing fee, which is often very unpalatable to business owners. If the private equity firm plans to take a payment at closing, this must be clearly stated and a cogent argument provided for doing so.

Value-add

Value-add may be the Achilles Heel of private equity firms when pitching family business owners.

Private equity firms may not perceive it as a weakness, however, and, in fact, may view it as a strength. But the value-add could hobble or cripple the chances of closing a deal. Private equity firms often believe they bring significant added value to a prospective portfolio company. That may not always be the case. It is critical that the firm knows your business. In some cases, private equity firms can demonstrate the expertise they can bring to bear on the business.

It can be difficult to imagine that an investor can bring meaningful know-how and skills to further grow the business of a sophisticated enterprise. On the other hand, private equity firms that can demonstrate expertise in product sourcing, acquisitions, international expansion or strengthening the executive team or board could be an asset to a mature business.

Chemistry

The baby boomer generation is as diverse as its numbers. An owner of this generation can be an urbane, sophisticated 40-something with Ivy League credentials, or someone from rural America who learned the business from the ground up and is nearing retirement age.

Regardless of background, the private equity firm should establish a true rapport with the owner from the start. The firm needs to be thoroughly versed in the company and its history, and the firm representative must clearly communicate an understanding of the business and a respect for the business owner and what you have accomplished. Ultimately, you must be convinced that the private equity firm is providing a fair valuation and an equitable deal structure. Select a firm that will be a true hopefully value-added partner that shares your vision for the long-term continued success of the company. •



M&A update: 11 months ended November 2008

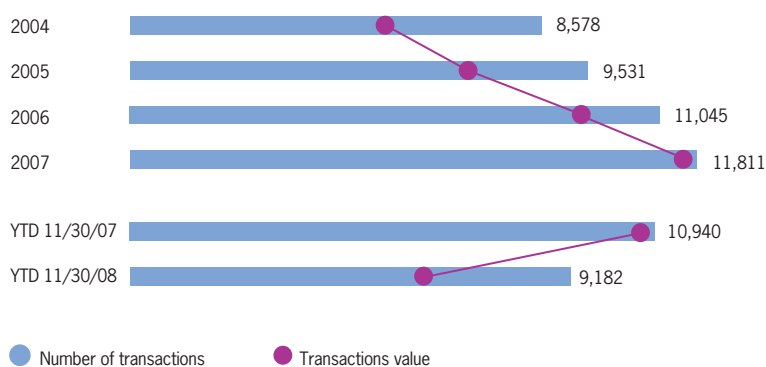
By **Len Batsevitsky**, senior associate,
Grant Thornton Corporate Finance LLC

Lower middle market provides silver lining for M&A

While news about the global credit crisis and equity market volatility continues to grab headlines, transaction volume for divestitures and acquisitions has been constrained. According to data from Capital IQ, announced U.S. mergers and acquisition transactions (M&A) totaled \$1.13 trillion during the first 11 months of 2008, a decrease of nearly 34 percent from the first 11 months of 2007. However, the *number* of U.S. M&A transactions dropped far less at approximately 16 percent, with 9,182 transactions announced during the first 11 months of 2008 as compared to 10,940 transactions during the same period in 2007.

It appears that after several record years of activity, the market has returned to levels last seen in 2005. Challenging macroeconomic conditions — such as decreased consumer spending, reduced liquidity and increased credit quality required by lenders — have burdened both buyers and sellers. Financial buyers, especially private equity groups, are having a tough time securing sufficient debt (leverage) to make transactions economically feasible and provide adequate returns to their investors. The volume of financial sponsor-backed transactions for the first 11 months of 2008 reached its lowest levels since 2004, posting a decline in excess of

Announced U.S. M&A transactions



Source: Capital IQ and GTCF Research

70 percent over the previous year. Further, the majority of the recent “megadeals” have been the result of consolidation within the financial sector as a result of necessity (merge or fail), not necessarily strategy.

Accordingly, the M&A market has shifted to a higher proportion of lower-middle-market transactions where acceptable deal metrics remain abundant. As the data shows, deals are still getting done — especially in the lower middle market. According to Capital IQ, announced U.S. middle market M&A activity (deal sizes of \$750 million or less) fared considerably better than total M&A market activity during the first 11 months of 2008, with the number of transactions declining only slightly more than 10.5 percent compared to the same period in 2007.



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Even more impressive, the number of lower-middle-market deals of less than \$50 million declined only 6.5 percent during the first 11 months of 2008 (not bad, considering 2007 was a record year). To put it in perspective, the middle market saw 3,471 transactions announced during the first 11 months of 2008 (2,458, or 71% of which were \$50 million or less), which represents an average of 315 deals per month, or about 10 deals per day. All things considered, this is still significant deal flow.

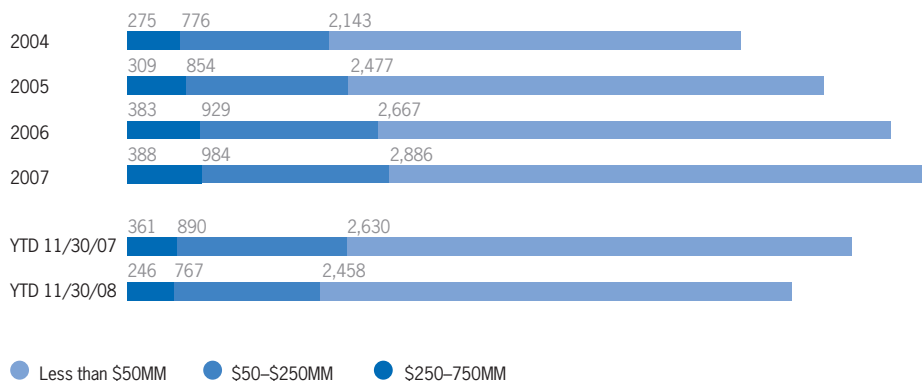
Record private equity fundraising year

2007 was a record fundraising year for U.S. private equity, with nearly \$300 billion raised according to the *Wall Street Journal*. Although a large amount of newly raised capital remains sidelined due to the current changes to the credit market, these funds will need to be either deployed in the intermediate term or returned to investors. As private equity managers are not in the business of returning the fruits of their fundraising activities, many industry experts have theorized that by the end of 2009 and throughout 2010, a number of financial buyers may actively and aggressively return to the market (assuming a more stable and normalized credit environment).

Effect of the economic recession

On a positive note, support for M&A activity has come from numerous strategic acquirers that have been lured to the market by the notion that bargains, resulting from the challenging economic climate and reduced competition from financial buyers, abound. Corporate purchasers with stable balance sheets and access to the necessary capital reserves benefit the most from the current economic climate. They can act quickly if attractive potential targets become available.

Announced U.S. middle market transactions



Source: Capital IQ and GTCF Research

Organic growth can languish during difficult economic times, making smart synergistic strategic acquisitions a great way for companies to boost sales and profitability. This notion may explain why corporate purchasers have recently intensified their activities, searching for value before market conditions can stabilize.

With purchase price multiples declining during 2008 after large run-ups in 2006 and 2007, the current atmosphere can be viewed as a “buyer’s market.” According to Standards and Poor’s, the average purchase price/adjusted EBITDA for deal sizes less than \$250 million has declined to the low sixes for the last 12 months (LTM) through November 2008, as compared to the low eights during 2007. This valuation is in line with levels last seen in 2004. For larger deals (\$250 million to \$499 million), however, the average purchase price/adjusted EBITDA has only declined to the low eights for the LTM, versus mid-eights for 2007. That being said, many sellers are still finding that they are garnering appropriate valuations for the sale of their businesses.

Sovereign wealth funds

Along with strategic acquirers, foreign investors, such as sovereign wealth funds, will play an increasingly important role in the future of the U.S. M&A arena. The global economy has become more interconnected, with fewer restrictions on the free flow of capital. With the recent declines in U.S. dollar exchange rates against several Asian currencies, most notably the Chinese yuan and Japanese yen, U.S. acquisition opportunities have become comparatively less expensive for companies in these countries. Many foreign investors are seizing the moment to capture undervalued business assets or make tactical investments in businesses, while at the same time receiving the diversification benefits of making such purchases. Of note, within the last three months the U.S. dollar strengthened against European currencies including the euro and the British pound, which partially offset some of the U.S. investment activity by buyers from those regions.

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M&A update: 11 months ended November 2008 (continued from page 4)

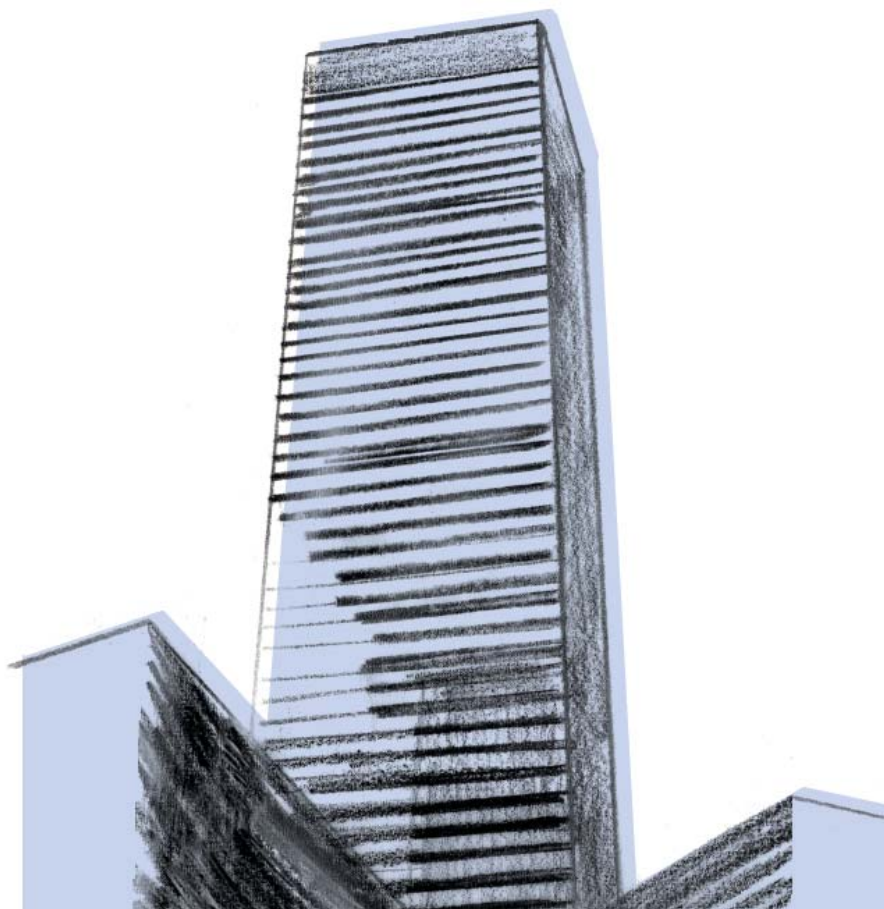
According to Global Insight, “sovereign wealth funds have been growing at a staggering 24 percent annually for the past three years.” These funds represented a combined \$3.5 trillion in 2007. If the annual pace of growth continues, sovereign wealth funds will surpass the entire current economic output of the United States in the next seven to eight years. Accordingly, the importance of sovereign wealth funds as investors in the global marketplace is anticipated to intensify as these funds continue to swell with debt-free cash.

Although U.S. investment by sovereign wealth funds has been somewhat derailed by the financial meltdown in September 2008, their sheer size, need for diversification and ability to selectively leverage favorable exchange rates make them potentially important players, along with other forms of foreign investment in the near-term deal market.

Future outlook

Overall, 2009 should prove to be challenging for M&A, with declines in deal volume affected by uncertain financial conditions around the globe. In the near future we can expect continued volatility in M&A activity as ongoing financing challenges and higher capital costs persist to limit flexibility for buyers. A greater proportion of strategic acquisitions in relation to purchases led by financial bidders should carry on in the near term, as well. Lenders will likely continue to demand increased amounts of sponsor equity, resulting in a paradigm shift away from megadeals to a greater focus on the middle market, where substantial unrealized value still exists. As a result, this subsector of the M&A market should experience the largest percentage of deal flow.

While the impact of recent government intervention to ease the credit markets is yet to be determined, financial buyers may accelerate purchasing activities in the longer term as credit markets stabilize and the vast amount of sidelined capital is deployed. Accordingly, corporate acquirers, which have partially offset the recent declines in M&A activity, should see increased competition for deals from financial buyers (and foreign investors) in the long run. •



The credit crunch: a practical guide

By **Len Batsevitsky**, senior associate, Grant Thornton Corporate Finance LLC

Understanding the implications of today's credit environment is of vital importance in managing a successful business organization. To that end, Grant Thornton released *The Credit Crunch: A Practical Guide* to assist managers and owners in meeting the daunting task of assessing their business operations under the current market conditions. The guide's 10-point checklist includes suggestions that are good business practices at any time, but are especially important considerations during a recession.

Following is a summary of items the 10 points covered in the guide.

1. Cash is king: If you have cash on your balance sheet, you have a greater degree of flexibility in your decision-making. In a slowing economy, understanding and managing cash flow are of paramount importance. Customers are likely to pay their bills more slowly, sales and profitability will likely diminish, and banks are less inclined to lend against insufficient or aging collateral. Liquidity can become constrained very rapidly.

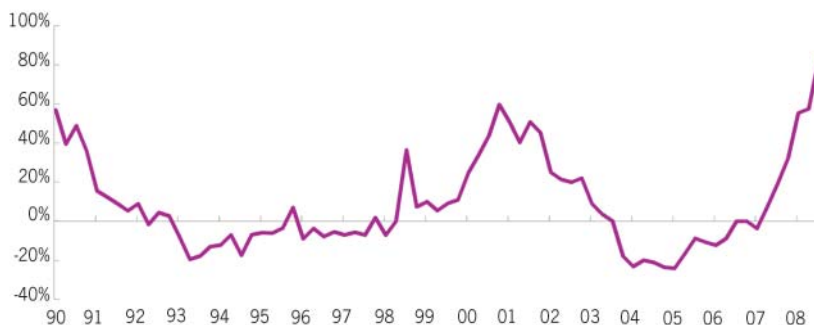
2. Be relentless in cost control: In order to maintain your current or historic levels of profitability in an environment characterized by decreasing demand and volatile commodity prices, you will almost certainly need to cut costs and spending where possible. Escalating costs will cause margin compression and, in turn, put pressure on liquidity. Tough economic conditions require a razor-sharp focus on cost containment at a minimum, and cost cutting where possible.

3. Evaluate customers and suppliers: Make sure you understand the financial well-being of your customers and suppliers. Look for signs of financial distress and express your concerns. Ask for financial information on a regular basis and analyze it carefully.

4. Get smarter on tax: It is important to take appropriate advantage of the opportunities available to reduce your tax liabilities, such as fully utilizing available credits and deductions and making the least allowable estimated tax payment.

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Net percentage of domestic lenders tightening standards for commercial and industrial loans



Source: The Federal Reserve Board – survey of senior loan officers October 2008

The credit crunch: a practical guide (continued from page 6)

5. Reconsider capital investment

plans: Carefully consider your capital investment plans and question the proposed value and timing. It is essential to weigh the operating and tax benefits of the investment against the financing costs, especially in a lending environment that has become considerably more challenging. If an investment isn't mission-critical, consider delaying or deferring it. For a mission-critical asset, negotiate to acquire it under the most favorable terms.

6. Get closer to your bank(s): Given the current state of the credit markets, banks will be much more cautious and concerned about credit quality. As a result, they will need greater persuasion to lend you money when you need it. In many industry sectors and geographic areas, new lending will be severely restricted, and you may struggle to refinance existing credit facilities. Treat your bank as a partner in the business. Keep them informed and help them understand your business, your industry and competitive dynamics. Be sure to give them plenty of notice if you need help.

7. Consider your financing options:

Make sure you understand all your options for funding your business. Start with your incumbent lender and consider alternative ways of structuring your current credit facilities. Don't forget to consider other types of outside financing including subordinated debt, private equity and venture capital. Finally, don't forget about creative ways of accessing cash that might be tied up in the business. Shortening your cash-conversion cycle should be a priority.

8. Keep an eye out for bargains: Be alert to acquisition opportunities where business valuations are falling and where business owners are looking for quick exits rather than risking survival through a difficult economic period.

9. Protect your personal wealth: In the current economic environment, it is likely that businesses will have greater borrowing needs. Banks will want more security in the form of personal guarantees, additional collateral and more stringent debt covenants, even on existing loans. Solving business cash needs with personal assets will reduce the diversification of your overall personal net worth and further expose you to a long-term recessionary economy.

10. Worst-case scenario: You've taken a hard look at your business and realized that your cash-flow outlook is bleak and your balance sheet is leveraged. Don't panic! Call professionals as far in advance of a financial crisis as possible. The more time you have to identify your options and craft a plan, the better your chances of success.



To download a complimentary copy of *The Credit Crunch: A Practical Guide*, visit Grant Thornton's Web site at www.GrantThornton.com/thinking.

Understanding the implications of today's credit environment is of vital importance in managing a successful business organization.

Grant Thornton Corporate Finance news

Grant Thornton Corporate Finance LLC announces the expansion of its team with the addition of the following professionals.



Lorene Dziurda
Senior associate

Lorene Dziurda, senior associate. Dziurda has more than 10 years of professional project management experience including corporate communications, technological implementation and training, and regulatory compliance. Prior to joining Grant Thornton Corporate Finance, Dziurda was the manager of special projects at Stout Risius Ross, Inc.



Brian Lee
Associate

Brian Lee, associate. Lee's primary role will be to assist with buy/sell-side advisory and with middle-market M&A transactions. He joined Grant Thornton Corporate Finance in August 2008 after previously interning with the firm. Lee earned a B.S. in business management with a concentration in finance and accounting from the Carroll School of Management at Boston College.



Nisha Mehta
Associate

Nisha Mehta, associate. Mehta's primary role will be to assist with buy/sell-side advisory and with middle-market M&A transactions. Prior to joining Grant Thornton, Mehta was an associate at Amherst Partners of Birmingham, Mich., where she performed research and financial analysis for M&A deals and financial restructuring. Previous to this, she served as a credit analyst at JPMorgan Chase.

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About Grant Thornton Corporate Finance

Grant Thornton Corporate Finance provides boutique investment banking services to privately held middle-market businesses in the United States and around the world. As a recognized advisor on middle-market mergers and acquisitions, we offer a range of investment banking services including sell-side advisory, buy-side advisory, management buyouts, restructurings and capital raising. Grant Thornton LLP provides investment banking services through its wholly owned broker-dealer subsidiary Grant Thornton Corporate Finance LLC, member FINRA, SIPC.

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