MERGERS AND ACQUISITIONS

THOUGHT LEADER FORUM

Perhaps no event has the potential to stress an organization more than a possible merger or acquisition. The Portland Business Journal gathered experts in the M&A field to share best practices, and provide advice to surviving – and thriving – in the M&A world.

At the table were Jeff Cronn, partner at Tonkon Torp LLP; Ben Lenhart, partner at Tonkon Torp LLP; David DiLorenzo, partner at DiLorenzo & Company; and Rodger Adams, senior partner at Veber Partners. This Thought Leader Forum was moderated by Erica Heartquist on behalf of the Portland Business Journal.

Erica Heartquist: Where are we in the current M&A cycle, and how has it been affected by the business cycle generally and by business owner demographics?

Rodger Adams: As everyone knows, the economic conditions are pretty good right now and that contributes to an excellent M&A market, but it's not just the economic conditions that cause that. There are other things as well; among them is low interest rates. So, there's lots of relatively inexpensive debt capital available to do deals and lenders are very aggressive. If a buyer can lever an acquisition more heavily, then less equity is necessary to fund a deal and a buyer can afford to pay more. Also, financial buyers, like private equity groups that are buying companies without explicit strategic considerations, have a large overhang of capital available right now causing them to be aggressive. Strategic buyers that are competing with the financial buyers need to up their game a little in order to compete pricewise with the financial buyers.

Benjamin Lenhart: The market has been pretty robust for a while and it seems that at some point it has to end. When you look at historical M&A cycles, we are closer to the tail end of a cycle. It's just unclear how long the momentum will continue and what circumstances will signal that we are on the downside of the curve, whether it's a general downturn in the economy, increased costs of capital (higher interest rates) or some other crisis, like terrorist attacks or more natural disasters. That said, I remember a few years ago feeling like we're close to the top. Hopefully, I am wrong.

David DiLorenzo: I think it's wise to compare it to five years ago because 2012 was a tax driven environment. There's two truths from five years ago: most people operating the companies, especially in Oregon – founder companies – they are now all five years older. The other trend is like most things in life (laughs) it goes to millennials and what have they to do with this? What millennials have to do with this is the interest level in family business succession is very different from what it used to be. There are a lot of people, typically founders of the company, hanging around. Maybe their kids will be interested someday but they don't want to do anything yet. That's a long run trend. I'm sure that's what you guys see. That's what I see. There doesn't seem to be as much interest in family succession, so there's only two spots left. It either goes to third party sale or management buyouts. Leverage is the same and I think it tilts to a third-party sale because of the inventory. What do you guys see?

Jeffrey Cronn: I agree. I think to follow up on that comment, five years ago there were a lot of family businesses that weren't selling, there was a level in the market where deals at 40-50 million were happening and deals at 10-12 million weren't happening and that created additional supply. As the time has run, there's a big group demographically that need to exit and that's providing supply to the market which is very active with buyers right now. It doesn't mean that all businesses are selling for at the top of the market because that hasn't been our experience. You can have the hottest market in the world, but if you're not a prepared seller, it doesn't mean you're going to sell at a high price. But, if you are ready to present and you do present well, you can get a very active interest in what it is that you're offering.

Adams: I think the baby boom generation, we're in the heart of their period of time in which an exit is becoming ever more important and so it's interesting to see what the Gen X and the millennials will do. When I first started in this business, we were talking about the post-war generation exiting and it's sort of sobering for me that we're now talking about my generation being the one that's exiting. But, that's certainly where we are right now.

Cronn: There's a real opportunity and an opportunity cost also because businesses can be run past the top of their lifecycle and start to decline based on energy, investment, planning for the future, etc., and if you don't exit at the top of your own business lifecycle, then values start to diminish as management resources decline, as customer relationships decline, etc. So there really is a time in which you can achieve a top value that diminishes on-going owner time commitments.

DiLorenzo: I think what makes that happen though is that the other side of selling requires someone to be at their magic age; otherwise they simply do not want to retire because they need something to do. I'll endorse everything you said Jeff, but I think what happens is that a hard-driving growth business ends up converting to a lifestyle business.

Adams: As an owner gets older, they're likely to be more conservative in their approach to the business. And there's nothing wrong with that, in fact it's prudent. Optimizing sales value is not for everybody. Every founder thinks differently. A founder wants a nice price tag at the end but that's not the sole item that drives the way they operate their company or the way they make their decision to sell.

Lenhart: I think the challenge is that you have to look at whether the founder has the ability to fund their retirement and the lifestyle they want

CONTINUED ON PAGE 21

SPONSORED CONTENT

THOUGHT LEADER FORUM: MERGERS AND ACQUISITIONS

JEFF CRONN

PARTNER, TONKON TORP LLP

Jeff is a partner at Tonkon Torp LLP, and has served as Chair of the firm's Business Department since 2008. Additionally, he is an active member of the firm's Corporate Finance and Financial Services practice groups.

His practice emphasizes mergers and acquisitions (M&A) transactions, shareholder disputes, and a range of corporate and business matters. Jeff regularly counsels public and private businesses, and family entities, with respect to M&A, corporate governance, securities and financings, and other general corporate matters. He also regularly advises clients with regard to shareholder and partner disputes. Jeff is a frequent speaker before various industry, Oregon State Bar, and professional groups on the topics of corporate governance, M&A, and finance issues.

He is a founding member of Marathon Scholars, a college access program for low income children, is a director and Treasurer of Oregon Humanities, and is actively involved with literary and other nonprofit organizations in the Portland area.

BEN LENHART

PARTNER, TONKON TORP LLP

Ben is a business law partner at Tonkon Torp. His practice focuses on mergers and acquisitions (M&A) transactions – representing both acquirers and targets. He also advises clients on a range of general business issues as well as corporate and securities law matters.

Ben particularly enjoys working with clients on business transition preparation and planning and has extensive hands-on experience doing this work. He joined Tonkon Torp LLP in 2017 as a partner in the firm's Business Department, after working for 20 years as an attorney with Lane Powell PC.

Ben has been recognized in Chambers USA: America's Leading Lawyers since 2008, for his skill in corporate matters relating to mergers and acquisitions, corporate and securities matters.

DAVID DILORENZO

PARTNER, DILORENZO & COMPANY

David is a founding Partner with DiLorenzo & Company, Certified Public Accountants where his duties rotate among M&A/succession /business transactions consulting and serving as Director of Tax Services.

David's M&A consulting practice is inclusive of buyer assistance engagements, seller assistance engagements, accounting and tax diligence, transaction structuring, tax aspects of buyers and sellers, post-closing mop-up and transaction integration. Best fits would be for closely held small to mid-market buyers, sellers and targets.

The firm's tax specialties focus on M&A taxation, estate/gift/trust tax, tax dispute representation and US tax aspects of foreign transactions. The firm's well rounded commercial tax services are best focused in the manufacturing, distribution, technology, agricultural, real estate, professional and high-value-add services sectors.

RODGER ADAMS

SENIOR PARTNER, VEBER PARTNERS

Rodger Adams is a Senior Partner at Veber Partners, a Portland-based investment banking firm focused on serving regional middle market businesses. Rodger has been with Veber for over 20 years, specializing in sell-side advisory services and private placements of debt and equity. Prior to Veber, Rodger was a Managing Director with PacifiCorp Financial Services in Portland and New York City.

Rodger has served on the boards of several Pacific Northwest companies, including CRU DataPort, Northwest Polymers, Pony Lumber Co., and Mass Ingenuity. He earned his BA from Humboldt State University, and an MA and MBA from the University of Oregon.

CONTINUED FROM PAGE 19

with their declining participation in the business. That's really the issue. If they have a great business that's kicking off a lot of cash flow and they don't need to be involved, that works. But statistics tell us that in a majority of closely held businesses (something like 80 percent), the majority of the owner's wealth is tied up into the business and at some point those owners will need liquidity. What you're talking about makes it harder for owners, because if they don't time the market and M&A cycles right, they're going to get lower value and may be unable to fund the retirement lifestyle that they really want.

Adams: You're talking about when you remove the owner's role and compensation as an employee from the equation.

Lenhart: Right, and the other point you said that's related, is that people don't want to retire. But at some point, physically, they will. What if they have a heart attack? If they haven't transitioned or prepared themselves for transition, they're going to have a serious problem. Because if they are the key at the business, if they've got all the relationships, if they've got all of the know-how, what do you do with that business when the founder is no longer in the picture?

Adams: This segues into the question of whether it makes sense to do a partial sale. That's one of the things that we as a corporate broker/dealer have seen quite a few instances of. It works very well when, as is often the case, the owner has his or her identity and lifestyle tied up in the business. As everyone knows, it's a really emotional experience to go through this sort of transaction. A partial sale allows an owner to take a half a step away from the business, maybe sell 70-80 percent to someone like a private equity group. He or she can stay involved as the CEO, or chairman of the board, or in some consulting role. That all depends on circumstances, but it allows the owner to continue to add value in a meaningful way and feel productive.

DiLorenzo: I've seen that over and over again. Where the rollover equity piece becomes very valuable. Now the funny part about it is that the founder is selling, and what I hear all the time is that they're focused on the cash liquidity piece that comes off the table and they want to be pretty sure they'll collect the seller note. But, they watch that one a lot and then eventually they say 'oh, that roll equity might be worth zero, so I need to be willing to do the deal as if that's worth zero.' And then of course it ends up that the roll equity piece becomes very valuable.'

Adams: If you can think of it as frosting on the cake, that's fine.

DiLorenzo: It's also really tax efficient. I like the rollover equity design because it's hedging. So to go back to your point Ben, you're not sure if this is the right time to sell or not, it's a good hedge, you know? You have a guaranteed amount that you take off the table now but you aren't sure if it was the right time to sell or not so it's an excellent hedging move and it's very tax efficient. And, here's how I describe the tax efficiency of the roll piece: if you sell 100 percent, you're selling the one investment that you knew the most about, pay full tax and then have the burden of reinvesting it. I believe that reinvesting is a burden. So why not, on the roll piece, not pay tax, think of that as a new investment because it'll be different. There's a different owner, but it's still an investment that you know an awful lot about. So, why not reinvest in something that you know an awful lot about and reinvest with the pretax dollars.

Cronn: Yes, and the first cautionary aspect is: who's your partner. It sounds good in theory and for corporate finance types, it makes all kinds of sense: it's tax efficient and it's informed. But, what I get often is 'I hate the way they do things,' and 'this is just not the way we do things.' It's an issue of control, significantly, for founders and other longtime business operators. They have a great passion for the way the business operates and a great passion for their employees, their customers, and what they've built. And, I often see primary disconnect with the wrong partner where partial-selling owners don't view the business in the same way as their new partner. They don't look to maximize economics in the same way as a financial investor. It's not a financial investment to the historic owner. So, at a top level to do this successfully, to me for an owner, it's very important to spend time to figure out ahead of time 'what is it that is most important to you? What's the plan? Is it financial return? Is it taking care of the employees? Is it a continuing participation interest in the business operationally or otherwise?' If you don't know ahead of time, you'll find yourself down a path and you might be someplace that you don't really like.

Adams: I was going to lever off your notion, Jeff – you're exactly right. So therefore, it's really important to design the right operating agreement and the right 'buy/sell' agreement during the first transaction to make sure that you're comfortable with the way things are going to work going forward, and unwind if they need to unwind. Don't take that lightly, be very serious about it. And, engineering the agreements as divorce documents, not marriage documents because divorces do happen regularly, not always, but certainly from time to time. All those things Jeff talked about can create some dislocation. If you've got good agreements, at least you've got the ability to mitigate the outcome with respect to how you get out appropriately.

Lenhart: I agree. I think the one step before that, and this is something that Jeff would probably echo, is that doing a deal with an equity rollover – whether it's a 20 percent or a larger. It really is a marriage and you need to take your time because typically and this is a generality, but typically the equity rollovers involve private equity transactions. When you're structuring that, it's really understanding who the buyers are. It's like interviewing and kind of dating the private equity firms on 'whose values align with what I want?' and all the components Jeff mentioned. I had a client a few years ago, he was an amazing operator and great at his business. He interviewed like six different PE firms and had six different offers and he picked the one whose values most aligned with his and it has worked out really well. But, if he had picked someone else and what Jeff was saying that they have different views on how the business should be run, that's where issues start coming up. And that's where the legal documents need to comprehensively address problems when they arise in a manner that works both for the owner and the PE firm.

DiLorenzo: As Jeff talked about, there's a huge difference in passion. You know, your founder is very passionate and now they might be married to very dispassionate people. You know, they just never agree on anything. The dispassionate person always replies, 'Well, that's just an emotion,

CONTINUED ON PAGE 22

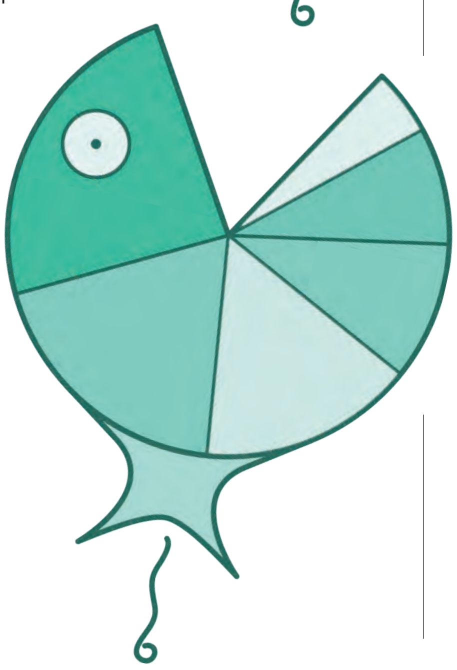
SPONSORED CONTENT

CONTINUED FROM PAGE 21

it doesn't matter,' and the passionate person might quietly think, 'don't you have a soul?' That's the backdrop. But the other specific areas? A big one is debt. It's pretty common for a founder to be proud of the fact that it's a low debt company and then a buyer, with identical facts, might mock the founder for his or her underutilization of debt, calling it an inefficient capital structure. Another area is cash flow. Cash flow is a big one, cash management. This could go both ways. It could be that a happy deal is where a founder never had money and now for the first time, there's good capital and there's lots of money. That's a real happy result where cash is better. But, it could be the opposite, where it was a cash cow and there was always plenty of money and the founder was proud to keep millions of dollars in the bank and have a high cash value. And, now with a buyer, money moves to headquarters. There can be a big disconnect.

Cronn: I think most fundamentally, there's a totally different perspective between focusing on a balance sheet as an operating company versus focusing on a balance sheet as a financial investor. And, it's very often difficult for operators to take that different perspective as to what they have. To Dave's point on debt, operators often think about a balance sheet: 'If everything goes wrong and in the worst case, can I keep the doors open?' and it makes all kinds of sense at that point to have very little debt and very little fixed monthly cost. Financial buyers look at a balance sheet for purposes of return on equity says, 'No debt? Where's my leverage? I'm not getting the return that this investment demands.'

Adams: One of the interesting aspects of that, of course, is that private equity groups can afford to take a portfolio approach to ownership because PEGs generally own lots of different companies so they can run up to the edge and be more aggressive with each of the individual companies. If one fails, they've got all the rest, so they're optimizing the performance of the portfolio, rather than each single company. The owner/operator just owns the one and so he has a different point of view on it.



Cronn: For many operators, if your business is a majority of your net worth, does it really make sense not to pay a huge amount of attention to that asset and seek to diversify and seek to spread the risk so that you're less dependent upon the month to month, year to year success of on-going business operations? But that's a very different perspective than most operators bring to the business. It's not an investment, it's an operating business.

Adams: We see a lot of owner/operators underestimate the risk of their business. Of course they understand their business very well, but to have 80 percent of their net worth tied up in one asset is concerning as you get older. It starts to become inappropriate. So, to figure out a way to diversify your assets is the right thing for an owner to do as they get older, for their family and all the other personal considerations. We advise people to look at that with clear eyes and try to move them closer to the efficient frontier, to diversity their holdings so that they're not totally dependent on their business because extrinsic things can happen outside their control.

Heartquist: So when should planning begin and are there legal and financial steps that should be taken ahead of a transaction?

Lenhart: Every business is different, and every owner is different. But, you need to be thinking as an owner what your realistic timeline is. And, you should be planning to sell, even if you don't plan to sell. Be prepared. If you're not, you either miss the market or you end up in a place where you're highly concentrated in an asset that you may not be able to unload.

Adams: One of the things I often say is, 'build the business to sell the business even if it's not for sale'.

Lenhart: That's exactly right and you may make conscious choices like 'okay, if I was going to run this as if I were going to sell it, I might make some capital investments that I am not going to do because I want the cash flow because I want it to fund my lifestyle. But at least you're making a conscious choice when you do that versus 'okay, I'm just going to take all the cash and not worry about when I'm going to sell and then you get to the point where it's like 'wait a minute, I need to have sold and now it's too late for me to make any kind of longer term investments because my horizon is so short.

DiLorenzo: Let's give the readers some specifics. I'll throw a couple out on the table. I think one specific for getting a business ready for sale is what the legal community calls "pre-pack." I think you should take whatever structure you have and you pre-pack a target and what that means is you only have in there the operating assets and the operating liabilities that are necessary to run the core business. One way or another you take out all the excess assets. If there's too much excess cash, get it off the table first. You'll have a higher return. Bringing inventory under control helps to take excess assets off the table and get the personal assets out, the artwork for instance. Take too many cars out, take all the personal assets out. I think those are several things you can do; just prepacking it. Create just the object for sale and keep everything else somewhere else.

Adams: One of the things that's really important is to build the bench strength in your company. This applies particularly to owner-operated companies where the owner has been the leading light and the driving force in the company. The owner needs to plan for the occasion when he or she is not there. And to have the bench strength behind the owner – the second level of management that can take that on. That's what financial buyers are going to be looking for, and also what strategic buyers are looking for, usually. So, you need to take care of key managers, the men and woman that are really important to a top-rated company and plan for your departure in that way.

Cronn: Any buyer wants to buy a certainty of cash flow at low risk at a low price. But when you think about the transaction process, having longer term agreements with multiple customers moving from 30 day contracts with two primary customers to two and three-year contracts with five primary customers is a totally different value proposition for somebody looking at your business. To Roger's point about employees, I often see owners not paying a great deal of attention to the employee aspect of a pending transaction. Some do, and some plan for a long time. And, for others, it's a complete blind spot and the reality of it is that for many employees, this is their job, it's their livelihood and a transaction is a tremendous amount of uncertainty. So it's not a positive, it's a negative. The way to address that is to align employee incentives with owner incentives by contract, by equity, and by other techniques. You need to think about that more than six months before you're going to do a deal.

Adams: What you're talking about is optimizing the sustainability of the cash flows for the buyer and if you think about it that way, then the things to do to make that happen become obvious. Another factor that people often ignore is customer concentration. It's easy to see how owners get into that situation. A company serves a good customer that becomes stronger and more important, and before you know it they represent 50 percent or 60 percent of the business' revenues or profits. It's understandable if that happens, but a buyer is usually going to look at that as a negative due to the dramatic potential risk of losing that customer. Sometimes, there are things you can do to reduce the concentration, but that might take three, four, or five years.

Heartquist: What the effect been of prospective tax and regulatory changes promised by the Trump Administration (e.g. cutting business regulations, reducing corporate income taxes, and implementing tariffs) on M&A activity?

Adams: I can speak to the tax piece. In the public markets, those factors have already been built into share prices. The general consensus is that there has been some positive bump on balance from the prospect of lower corporate tax rates going forward. In the private markets it's binary, either you've sold or you haven't sold. So it may be slowing some people down to say 'wait a minute, maybe I should wait to sell my company until we know whether lower tax rates might enable a buyer to afford a higher price'. I don't think we're going to see anything on taxes this year. If we do see something, it will be next year. And if you're thinking about selling and you're starting this year, your deal won't be done until next year anyway, so it doesn't make too much sense to wait.

Lenhart: It's timing the market. Which history and Warren Buffett tells us can be a fool's errand. If you wait for the tax benefit, but while you are waiting the M&A cycle dips, did you lose more overall value by delaying than the you gained in tax savings?

DiLorenzo: I will speculate what could a seller, planning to sell expect. If the tax reform framework that the Administration just came out with, gets legs? This round of tax reform is not about capital gains, it's going to be very anticlimactic. Maybe it goes from 23.8 to 20 if they can take the net investment income tax off, but I think that's tied to health care. I think if you're a partnership or an S Corp seller and if you're hearing that the buyer doesn't want to buy your equity, they want to buy your assets, and you've been trained for years and years to not do an asset deal, this is where I see the opportunity. What might happen in Framework for the first time ever, there might be this new tax rate called a pass-through entity rate and they're talking about applying a 25 percent tax rate. Think about that, 'wow, if I got stuck with an asset sale, well that's not so bad.' That would change our world for S Corp and Partnership sellers if suddenly the tax cost of an asset sale becomes similar to the tax cost of an equity sale.

Cronn: I've heard a pretty consistent comment from buyers and sellers since the changed administration which is, 'we don't know what's going to happen, if anything, and we don't know when it's going to happen.' You can't make decisions based on fundamental uncertainty. So at the end of 2016, we had more deals deferred than I've ever seen speculating that it's not going to get worse. So the idea was, if 2017 is going to be at least as good as 2016, let's just wait until January. We had a bunch of deals that didn't close at year end as they would have. Right now, I don't see much active decision making based on federal tax reform, but again, some people are saying 'why don't we provide ourselves the opportunity to close in 2018 just in case.' So, we're getting to year end where people are establishing deal timelines and some of that is happening, but federal tax policy is not the primary driver of when deals are or are not closing.