Zachary Scott
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Zachary Scott—an investment banking and financial advisory firm—has published this newsletter since 1997 to bring you a thoughtful analysis of issues affecting middle-market businesses.

PERSPECTIVES ON THE CAPITAL MARKETS SUMMER 2015

INSIGHT

Preparing a Business for Sale—Part II: Understand the Problem

Specific actions need to be taken to achieve a competitive process.

by David Working

Investment bankers provide a variety of services to businesses, but a banker's primary mission is to create a competitive market for an illiquid asset—the privately held business. Competition invariably brings out the best, and a competitive market is created when each relevant and capable buyer simultaneously has a complete understanding of the opportunity. But for a decision on price, there are no unknowns. This article is the second in a series of three essays, each delving into a critical area in which advance preparation can make a meaningful impact on the ability to create a market for a business.

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come close. It requires specific actions on the part of owners and managers to prepare the business for a competitive process. Three areas that stick out in our minds are the subjects of our series:

- **Data matters; its absence leaves only a story.** The existence of and accessibility of data on the detailed operational and financial mechanics of the business are necessary to quantify the company's business model and how it employs its capital and earns its return.
- **Understand the problem your company solves.** The size and growth curves for the market, the number and nature of the competitors, and how customers make buying decisions need to be understood and quantified in a manner that defines the environment in which the company competes; understanding precisely which problem the company solves thereby creates the framework for defining each of these items.
- **The future course must be plotted.** There is a specific value proposition that underlies every business and customer buying

Part I: Data Matters

Part II: Understand the Problem

Part III: Plot the Course

Well-documented systems and data collection can address "what" and "how" the business operates, but not "why?", which gives perspective as to the future prospects of the business.

decision. What is it? The roadmap for future success has to be specific such that the equation for return on capital employed is clear to the potential next owner.

PART 2: UNDERSTAND THE PROBLEM

Part I of this series outlined the necessity of developing robust data systems inside the business being brought to market, for the purposes of proving the economic concept of the business. These systems, in essence, provide an internal perspective into what makes the business valuable. But a complete internal perspective only makes up half of the overall picture; the external perspective, or a solid understanding of the environment in which the business exists, is an equally crucial component to building a complete buyer thesis. If "a rising tide lifts all boats," then both the boat and the tide must be thoroughly explained.

Our experience is that the middle-market business owner, by necessity, influences the operations of the enterprise in numerous capacities, most notably from an internal perspective, trying to adjust to a constantly changing external environment. To continue the metaphor,

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the boat's captain can't change the tide, so he doesn't work to predict it.

Well-documented systems and data collection can address "what" and "how" the business operates, but not "why?", which gives perspective as to the future prospects of the business. Especially for businesses with complex business models, or in industries with seemingly obvious risk issues, buyers can be "scared away" from an investment before taking the time to investigate whether their intuition is correct. At the very least, extended periods of time will be required to allow adequate investigation. While an owner cannot force a buyer to share his own conclusions on the market, he can clearly illuminate a certain perspective.

There is a near-infinite amount of information that could be used in discussing a business environment, so we help our clients narrow the scope with three lines of questioning, each with a static and dynamic component:

1. **What customer problem does your company compete to solve? Or: what is your market?**
2. **How large is your market? How large will it be?**
3. **What is your market share? What will your market share be?**

Addressing the core question, "What problem does my company solve?,"defines the open questions of "who are my potential customers?" and "who are my competitors?". Customers are not always direct customers, but end users of the value chain. Competitors are not always those similar businesses, but other businesses and channels that attempt to solve the same end-user problem. As an example, a customer problem to be solved is "getting to work in time for a staff meeting." Cars, buses, light rail transit, taxis, bicycles, and van pools are all competing mechanisms to solve the customers' problems, each with a specific set of cost, convenience, and dependability attributes. Another competitor could be video conferencing, which attempts to solve the problem in a totally different manner. Customers are not just the people who use these methods, but all the people who have this same problem, and may even be without a current solution. Too often we see companies struggle to define exactly what the market encompasses, or who they consider their competitors—they allow a specific set of products or a certain class of customers to define a narrower view of the opportunity (or ignore a major source of competitive risk) than is warranted. By defining the specific need that the company's products and services address, and the "market" as the group of customers who are in need of the service (even if they leave the problem unsolved or solve it through a different style of products or services), and the "competition" as anyone else who seeks to provide a solution to the same problem—then the answers to the questions of market size, market share, competitive dynamics, and market potential crystallize out of that structure. The more the overall picture of a business environment "ticks and ties," the more likely it will lead to a valuable conversation in the sale process.

Quantifying the market, market share, and competitive attributes can be difficult for already busy managers, and requires a specific kind of research to provide a firm framework for the issue. Much like some businesses engage a "sell-side Quality of Earnings Report" from an independent entity, it might make sense to address this issue by engaging an additional resource (ranging from a dedicated internal resource, to a local university research team, to an external market research consulting firm).

We believe that the continual assessment of the business environment is important for the strategic direction of any operating company, not just those preparing for a sale. The earlier an organization can begin efforts to regularly collect data along their value chain, and allocate internal or external resources to interpreting the data for strategic use, the better prepared they will be to pivot those insights into tangible value in management decisions, as well as when a sale process begins. **ZS**

Deferred Tax Liabilities and M&A Transactions

DTLs can introduce unusual wrinkles in the sale of a privately held business.

by Jay Schembs

Privately held businesses are typically organized as pass-through entities (e.g., S-corporations or limited liability companies) for income tax purposes. Businesses organized as C-corporations, however, are obligated to pay corporate income taxes. This creates the potential for accounting treatment of deferred tax liabilities ("DTLs") on the balance sheet, especially when the business has a large fixed asset base. The DTL becomes a matter of value for buyer and seller in a stock sale transaction. This infrequent situation can introduce an unusual wrinkle that either or both sides may not fully understand and may not be adequately prepared to negotiate their impact on the deal.

BEYOND THE GREEN EYESHADE

From an accounting perspective, DTLs represent timing differences of income taxes payable between the company's financial accounting and tax accounting methods. DTLs occur when a company with a large fixed asset base takes advantage of accelerated depreciation methods for tax purposes. While the company's financial statements may show operating income and taxes payable based on generally accepted accounting principles ("GAAP") depreciation rates, the company actually pays less taxes than the amount recorded on its financial statements in the early portion and more taxes in the latter portion of the assets' lives. The difference between taxes payable as measured by GAAP and cash taxes payable is accrued on the balance sheet as a DTL. Early in the asset's life, the DTL account builds and is "drawn down" later in the asset life until the DTL eventually is eliminated. The following exhibit schedules out the accounting treatment for an example $50 million asset over its life.

The deferral of income taxes related to a specific capital expenditure will ultimately reverse. However, for businesses that continue to invest in fixed assets and retain the same tax

($000's)	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10	Yr 11	Total
Depreciation												
Tax (10 Yr MACRS)	5,000	9,000	7,200	5,760	4,610	3,685	3,275	3,275	3,280	3,275	1,640	50,000
Book (10 Yr SL)	2,500	5,500	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	2,500	50,000
Timing Difference	2,500	4,000	2,200	760	(390)	(1,315)	(1,725)	(1,725)	(1,720)	(1,725)	(860)	-
Incremental DTL	875	1,400	770	266	(137)	(460)	(604)	(604)	(602)	(604)	(301)	-
DTL Book Balance	875	2,275	3,045	3,311	3,175	2,714	2,111	1,507	905	301	(0)	

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policy on depreciation, the total amount of DTL on the balance sheet may not change as earlier liabilities are paid off, but are replaced by newer liabilities related to new fixed assets.

The fact that the account balance can remain stable over time gives rise to the accountant's view that, in this scenario, DTLs are more like equity than debt. That view is counter to the actual economics of the business.

THE ECONOMIC VIEW OF A DEFERRED TAX LIABILITY

DTLs affect value through their impact on future free cash flows. Operations are not affected by DTLs and neither is EBITDA. But, the after-tax cash flows of the business can be affected and represent a different future cash flow stream and value. It is the present value of the remaining cash effects of the DTLs that impact value.

As can be seen from the adjacent graph, the present value of deferred tax payments is always less than the DTL balance, although age in the life of the asset is a major determinant of the magnitude. When a group of assets with varying in-service dates and useful lives comprise the DTL balance, the analysis can become complex.

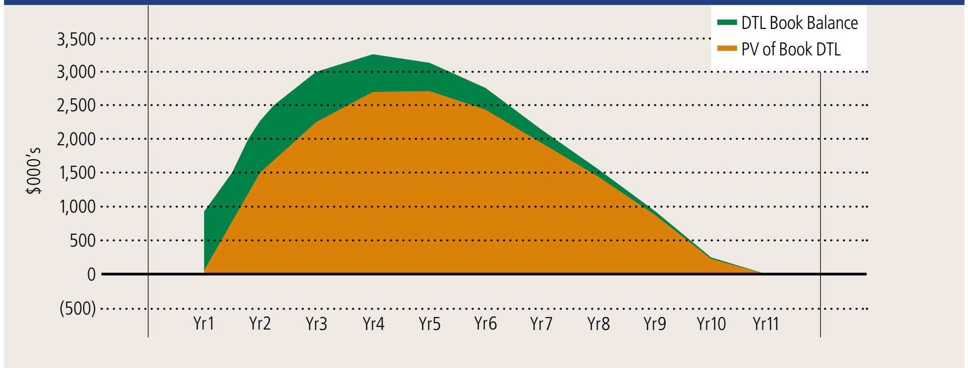
The argument that a going-concern business will replenish its fixed assets, thereby leaving the DTL balance stable is irrelevant because the free cash flow analysis determines the difference between having or not having a balance at a specific measurement point. So long as there is operating income to tax, the present value of cash flows will always be less than the GAAP DTL balance. In essence, the company has "borrowed" the tax shield from the future in order to increase cash flows early in the asset life. Because of the time value of money, this is a logical economic policy as the increased taxes at a later date are "cheaper."

WHAT HAPPENS IN A SALE TRANSACTION?

At the time of a sale, a sophisticated buyers' evaluation takes into account the expected future after-tax cash flows and assigns a value to the DTL separate from the value of the operations. That value, which represents the present value of the tax timing differences, is less than the account balance shown on the balance sheet as a result of the specific asset depreciation schedules, the tax rate, and the present value discount rate. In essence, the DTL value calculation is "debt" for transaction purposes.

Part of the reason why this can be confusing to the parties is that DTLs are not even considered in transactions involving pass-through entities. DTLs still exist, but they sit on the owners', not the company's, balance sheet.

DEFERRED TAX LIABILITIES



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At the time of a transaction, purchase price must be allocated for tax purposes (to the extent that there is value to allocate) to the lesser of market value or original cost of the asset. Assuming that economic depreciation approximates accounting depreciation, the difference between the asset amount on the tax books and the GAAP books is taxed at ordinary income rates. At the time of sale, all future tax differences are brought current in the form of depreciation recapture, thereby making the negative economic effect even greater to the seller than when measured against the same situation in a C-corporation.

The analysis is not an exact comparison because of the differences in personal and corporate tax rates, but the fact still remains—DTLs are not free. They represent value and are taken into account in transactions.

CONCLUSIONS

DTLs are "debt" in the economic sense, but with the following provisos:

- The amount of debt associated with DTLs is not the accounting balance; rather it is the present value of the remaining tax payment differential over the life of the assets. The amount depends on the specific schedule of remaining differential and the point in time of the asset life.
- Owners should understand that the company received the benefit of the lower effective tax payments during the period of DTL creation and, but for that, would have had offsetting cash or line of credit balances.
- For DTLs to have value as debt, the company needs to be expected to be profitable. A failing company has nothing to worry about.

Prior to beginning negotiations on the sale of stock in a C-corporation that shows DTLs on its balance sheet, it is wise to conduct an economic analysis of the DTL's impact on shareholder value. The buyer should be made aware of the tax situation prior to submission of a purchase proposal to ensure a fair valuation of the DTL is incorporated into the deal, and doesn't become an unexpected surprise at a later date. **ZS**

Transaction Bonuses for Executives

Help motivate key executives and employees during the sale process.

by Mark Working

Often in sales of privately held businesses, special compensation arrangements are made for executives and key employees. Bonus arrangements are made for at least several reasons: a sense of fairness and appreciation for contributions in making the business successful, extra work in support of the sales process, and an alignment of interests in making the transaction and transition successful. The amounts, timing, and forms of arrangement are all issues that must be decided and customized to each situation.

ESTABLISHING A REWARD SYSTEM

Putting aside "fairness" as a motivation, as each ownership group has their own meter and metric for what is appropriate for the situation and individuals, very practical reasons exist for establishing a reward system for executives.

Every business combines assets and people working within a dynamic system to carryout the everyday functions of the business. When

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all parts work in unison, great results can be achieved. At least one of the reasons why buyers pay high prices for a business is if they believe the "system" can be continued following ownership transition. Correspondingly, a significant due diligence effort focuses on assessing the ability to execute the company's business model, the identification of key employees, and the longevity and motivation of those key employees as the business moves forward.

Professional preparation for a sales process requires a company to describe how its specific business model works and why it is successful. That is almost always best accomplished with the involvement of the key people who direct and carry out the different functions of the business. When it comes to considering different potential buyers, these same managers will be involved in presenting the intricacies of the business from their perspective and answering questions arising during due diligence. They can be critical to achieving the best result for owners.

RISKY ASSUMPTION

Human resources are not assets on the balance sheet that can be transferred through a legal assignment. Individuals have their own motivations and ideas of what is best for them. Expecting them to fall in line because that is what would be best for the owners is a risky assumption. When an employee learns of a business being "for sale", their first thought is to determine what a transaction means for them. Despite most buyers wanting to retain the workforce, especially critical people, the usual assumption is that there will be layoffs or replacements. In any regard, change is expected and the unknown causes two destructive activities—replacing focus on business activities with thinking, talking, and imagining what the future will be, or taking action to find a new job where stability is perceived to be greater.

The primary goals of a transaction bonus program, consequently, should take the fear of change away while at the same time encouraging employees to embrace the new opportunity. The selling owner wants employees to keep their eyes on the business and know that it is in their best interests to assist in the sales process as directed by the owners and their advisors.

IDENTIFY KEY EMPLOYEES

Not all employees will be aware of or involved in the sales process. The first task in designing a program then is to identify the key employees whose loss would be detrimental to the organization. Most likely this will include all executive managers, but could also include certain others who have specific technical knowhow critical to the organization.

Generally, owners will benefit from approaching these employees in advance of a specific sales process with a message along the lines of:

"Options for selling all or part of the ownership's interests are going to be explored. You are very important to me and the organization and any new owner will desire that you remain on board, but in any case, I want you to feel protected against any other result."

The "Stay and Perform" agreement is the typical agreement used for transition situations. These agreements usually have two components:

1. Employee Promises. As a valued employee, the agreement provides for the employee to make certain promises to the company:

a. A non-disclosure agreement intended to assure no disclosure of trade secrets about the business that could be detrimental if known by competitors, suppliers, or customers.

b. A covenant not to compete agreement, if it does not already exist, assures that the employee won't leave and work with a competitor.

2. For the employee promises, the company agrees to pay to the employee:

a. A cash bonus at the time of a change of control transaction equal to an amount that reflects the special effort made to help prepare for and accomplish a successful transaction. This can be customized to the individual but often represents up to 50% of annual compensation; plus

b. A transaction bonus to be earned by the employee at the earlier of a certain amount of time passing following a transaction (often 6 - 12 months) or the loss of employment as a result of the new owner. Care needs to be taken to differentiate between employment being taken away from the employee and the employee leaving of their own accord.

The amount of the transaction bonus needs to be sufficient to deter the employee from searching for another job. Therefore, it needs to safely cover any gap in employment and risk of compensation change that could occur if the new owner decides their services aren't required. At a minimum, it should be equal to one year of compensation and any differential in future pay due to the non-compete (unless the non-compete is waived).

To be a valuable structure, the employee must appreciate and trust the fairness of the bonus calibration, as well as understand his or her role so as not to cause unintended consequences as a result of the incentives.

AVOID LAST MINUTE AGREEMENTS

It is better if these agreements don't need to be employed at the last minute. These agreements should be in place as part of normal course executive employment. Our recommendation has always been (see "Aligning Interests: Management Bonus Plans" IN$IGHT Winter Issue 2013) that the interests of owners and managers align, with value being a foundational component. If this has not been an historical part of the culture of the business, it is more challenging to implement at the time of a transaction. To be a valuable structure, the employee must appreciate and trust the fairness of the bonus calibration, as well as understand his or her role so as not to cause unintended consequences as a result of the incentives.

If implemented properly, key employees will embrace and fully support the desire of owners to liquidate their holdings, knowing that they will be protected from the risk of change, and buyers will gain confidence that the operating model will remain intact following ownership transition. As there are many subtleties to these arrangements, if is helpful for advisors familiar with these agreements and how they will be interpreted to assist in their creation. **ZS**

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