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Business Transfer & Valuation Information

VOLUME 6, ISSUE 1, 2009

Minimizing Earnout Risks

Creative deal structuring, such as earnouts, is becoming increasingly popular in today's M&A market. When access to capital is limited, earnouts can be an effective way to bridge the gap between the seller's expectations and what the buyer can pay. What does the term "earnout" mean? It is a contractual provision stating that the seller of a business is to obtain future compensation based on the business achieving certain future financial goals.

Earnouts are designed to align buyer and seller incentives post-transaction, as well as present an attractive option for dealing with current market conditions and valuation disagreements. However, they can be extremely complex and vague, leaving both parties vulnerable to operational risks and tensions created by conflicting interests. To minimize these risks, the earnout agreement must be meticulously structured to define the earnout formula, as well as address operational issues that may arise during implementation.

Successful earnouts start by negotiating smart, achievable targets, making sure they are clearly defined. As a seller, you should retain some control over decisions that directly affect your ability to achieve earnout targets. You will want to clarify your new role in the company, as well as your eventual exit.

Earnout targets are most commonly based either on revenue, gross profits or earnings. You will want to ensure these targets are

achievable. Recognize that what was reasonable under your management may not be reasonable under the new owner's management. Protect yourself up front; understand that the new owner may decide to operate differently.

If your earnout is based on net income, include a budget in the contract for capital expenditures, R&D, marketing and maintenance. This will prevent the buyer from incurring excessive expenses to shrink earnings (and your payment).

Gross profit targets can be more advantageous than net profit targets because they eliminate overhead costs. This ensures the purchase of a new ventilation system, for example, won't diminish your chances of hitting the earnout target.

Using revenue targets can simplify your agreement, as it is more difficult for a buyer to depress sales than to depress income (gross or net). But a downside of using revenue-based formulas is that you expose yourself to a buyer's preemptive tactics. For example, an acquirer who already has a competitive product may decide to take your product off the market following the transaction.

The most attractive option may be to base earnout payments on milestones rather than financial results. Milestone payments are more objective and in some cases can be preferable to both the buyer and seller. Milestones

include client retention, which can be measured by either retaining specific clients and/or retaining an overall percentage of existing customers. Booking a specific number of new customers by a certain date is another common milestone. As with all earnout targets, it is imperative that you make certain you will have the resources needed to achieve the targets. A substantial cut in the company's marketing budget could restrict your ability to obtain new customers.

To further reduce risk, sellers should seek "sliding-scale" rather than "all-or-nothing" payments, regardless of the agreed upon target. This can ensure that if you're within 90% of the target threshold, you will receive 90% of the payout, etc.

It is advantageous to use an experienced third party, such as an attorney or M&A adviser, when negotiating an earnout agreement. After all, you'll likely be negotiating with your future employer. Let your adviser negotiate a favorable agreement on your behalf, removing yourself from possible points of contention.

While no earnout comes without risk, negotiating a favorable agreement that is clearly defined will greatly improve your prospect of reaching targets and receiving the desired payment for your business.

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By Steve Jacobs

History has shown that an economic downturn can be a great time to start a new venture or make a targeted acquisition. In recent weeks our conversations with strategic buyers, private equity groups and bankers have reflected a “better” outlook than what we read or hear about from the media. No doubt there are many challenges affecting the global economy, but generally, with economic uncertainty comes the prime time to consider growth opportunities.

There is one commonality in business no matter what is happening in the economy – “Cash is King.” Now may be the right time for ultimately healthy companies to take advantage of weaker competitors, profit from falling valuations and build value.

Economic uncertainty can provide a silver lining for long-term strategic decisions, especially with competitors that may have made poor decisions during the past boom cycle. Well-run companies are still taking action through acquisitions and, in some cases, creatively selling segments of their businesses.

Also, many business owners are still interested in exiting quality businesses and will sell for a fair price. However, as a potential buyer, it can be difficult to differentiate your business from those bottom feeding businesses looking for distressed companies that must sell.

This is where using an experienced M&A adviser provides clear advantages to both buyer and seller. If you are interested in making a high-quality “niche” acquisition rather than just evaluating turnaround opportunities, utilizing the skills of an advisory firm will save time, money and, best of all, strategically differentiate your company from the competition!

Ryerson and Nalley Acquire CFF

BCC’s Al Ryerson and Jim Nalley were recently awarded the Certified in Financial Forensics (CFF) credential by the American Institute of Certified Public Accountants (AICPA). The CFF credential is granted to qualified CPAs with considerable professional experience in this arena.

Requirements to earn the CFF credential include demonstrating significant business experience, as well as completing a minimum of 75 hours of life-long learning and education activities, in the area of financial forensics. The CFF credential is granted exclusively to CPAs who are members in good standing with the AICPA, which binds them to the AICPA Code of Professional Conduct.

Ryerson and Nalley unite to provide expertise to their clients utilizing almost 50 years of combined experience in financial and management projects, business planning and projections, mergers and acquisitions, business valuations and litigation support. In support of these services they have each provided direct expert testimony in hundreds of legal cases involving personal injury, wrongful termination, corporate disputes, marital dissolution and business valuations.

Readers Recognize BCC

Once again, BCC Advisers was recognized in the “Best Business Consulting Firm” category in *The Des Moines Business Record’s* annual readers’ poll. The runner-up for 2008, BCC has earned one of the top two spots in this category six of the last eight years.

2008 RUNNER-UP
BEST
OF DES MOINES
BUSINESS RECORD

Harse Addresses UNL on Doing Business Globally

Brad Harse, BCC Sr. V.P. and Western Region Manager, presented a guest lecture at the Jeffrey S. Raikes School of Computer Science and Management at the University of Nebraska-Lincoln. Sang M. Lee, Chair of the Management Department, University Eminent Scholar and Distinguished University Professor, asked Harse to speak to his class of honor students on the topic, “Doing Business Globally.”

With his extensive international experience, Harse has conducted business in more than 30 countries on six continents. He speaks often with undergraduate and graduate business students (and faculty groups) on a wide range of subjects, including international business and business ethics.

The final message Harse leaves with his classes rarely changes. In addition to acquiring technical skills for their chosen discipline, whether it is management, finance, marketing, MIS, etc., students must hone their written and oral communications skills. Technical proficiency is of little value on its own, without the ability to effectively communicate with associates, clients, customers, suppliers and others.

Our Newest Acquisition

Matt J. Fett joined BCC Advisers in January, 2009, as Financial Analyst in the business valuation practice of the firm. Matt received his Bachelor of Science degree in finance from Iowa State University, where his academic career included studying international business in Alicante, Spain.

While at Iowa State, Matt completed a successful internship with AEGON Realty Advisors, which included providing market research for internal appraisers, analyzing financial statements and preparing rent rolls. Matt also worked part-time for the City of Ames in the Real Estate Inspections Division.



IMAP – A Vital Factor in Global Business

In this unprecedented economic environment, it is crucial for business owners to not only take advantage of smart, strategic opportunities, but to have access to the best possible opportunities available. With over 60 member firms spanning five continents, the International Network of M&A Partners (IMAP) has unparalleled global reach and market access; a clear advantage to our clients.

IMAP, more than any other global M&A organization operating in the middle market, completes transactions in all the major regions of the world. Annually we rank in the upper tiers of Thomson Financial's M&A league tables for completed transactions in the middle market. 2008 proved no exception as IMAP ranked in the top ten worldwide in number of transactions with values up to \$100 million. Also in 2008, IMAP was included on the European Private Equity Award's short list for Financial Adviser of the Year. Clearwater's Marc Gillespie (IMAP member in the UK) stated, "Our clients benefit from access to the most likely buyers and sellers from around the globe."

BCC has a strong relationship with Clearwater, in addition to our other European partners. Jan-Olof Svensson, Managing Partner of Nordic Merger AB in Sweden, said, "The dealmakers at BCC work persistently and professionally to help us on our projects. We are pleased to have such valuable assistance in the U.S."

Like many of the client companies we serve, IMAP continues to expand its network to maintain global relevance. For IMAP, that means being able to deliver industry expertise together with insight on regional

financial, business and social nuances from every business center in the world. In 2008 IMAP further strengthened its North American position by admitting two new U.S. firms: Morgan Joseph, headquartered in New York City, and Dresner Partners, based in Chicago. Additionally, quality new member firms, Key Capital in Ireland and Level Five Consulting in Austria, joined our European ranks as IMAP's exclusive Irish and Austrian members. Each of these leading M&A advisory firms demonstrate the ultimate level of integrity, expertise and industry knowledge required and shared by all IMAP member firms worldwide.

Managing director of Crosbie & Company in Toronto, Mel Margolese, stated, "It is the shared commitment to ethical standards and confidentiality that makes IMAP partners great teammates when working on joint projects."

IMAP has proven itself to be one of the most relied upon providers of M&A advisory services in the world. The world's oldest middle market M&A network with modern global coverage, IMAP plays a vital role in creating appropriate connections, collaborating with international partners to meet client needs, wherever they might exist.



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IMAP Conference – Amsterdam

Steve Jacobs and Tom Cavanagh attended IMAP's fall meeting in Amsterdam, the Netherlands, where they were able to share M&A knowledge and best practices among several hundred IMAP colleagues, as well as strengthen relationships around the globe.

During the conference, BCC made a best practices group presentation

titled "Proven Marketing Techniques to Potential Purchasers of Sell-Side Clients."

Also while in Amsterdam, IMAP, together with Thomson Reuters, held a joint press conference to present results from the Thomson Reuters IMAP Global Survey on current M&A activity and trends.

Global Partners Right Next Door



Through IMAP, BCC has established vital, worldwide partnerships that lead to greater opportunities for our clients. In addition to connecting buyers and sellers around the globe, IMAP colleagues also share resources and opportunities right in our own backyards.

Founded in 1991 and based in Chicago, Illinois, **Dresner Partners** is one of BCC's valued U.S. colleagues in the Midwest. Dresner's team consists of experienced specialists in the areas of manufacturing, business services, consumer products, health care and metals. Like BCC, Dresner serves a variety of clients ranging from entrepreneurs and generational family businesses to international corporations and institutional investors.

Collaborating on M&A assignments is customary among IMAP members. When Dresner Partners joined IMAP in July 2008,

an additional opportunity was recognized by both BCC and Dresner to better serve Chicago and the surrounding area by leveraging BCC's valuation expertise with Dresner's established, solid reputation in this metropolitan market. A valuation team was assembled from both firms to specifically serve this market.

"IMAP delivers superior levels of service and quality to all segments of the global middle market. I look forward to what our partnership with BCC Advisers brings to the table for our clients, both current and future," shared Steven Dresner, founder and president of Dresner Partners.



Steven M. Dresner

In addition to partnering on M&A assignments and business valuation projects, BCC and Dresner professionals participate in bi-monthly conference calls to share best practices and other value-added client services. Dresner added, "Communication with IMAP colleagues is the key to unlocking opportunities for clients that they may not have even known existed."

on the dotted line

Some Recent BCC Advisers Transactions:

.....
Advised on a joint venture investment and assisted in renewing senior-debt financing for a consumer products manufacturing company.

.....
Provided value consulting services to an equipment distributor for possible sale of the company.

.....
Prepared a fair market valuation of an agriculture products manufacturer for estate planning purposes.

.....
Prepared a fair market valuation of a bank for purposes of annual ESOP administration.

.....
Advised on a corporate renewal strategy for a U.S. manufacturer of coin operated games.

The Market Front

Some opportunities available through BCC Advisers:

U.S. specialty retail chain – is seeking a buyer.

U.S. exam preparation services company – is seeking a buyer.

European manufacturer of tire production equipment – is seeking a buyer.

Midwest-based private equity firm – is seeking acquisitions of dental practices.

South American manufacturer of truck bodies – is seeking a buyer.

Midwest sheet metal contractor/manufacturer – is seeking a buyer.

South American apple producer – is seeking a buyer.

U.S. contract manufacturer – is seeking a buyer.

For mergers and acquisitions, contact Steve Jacobs or Brad Harse. For valuations, contact Al Ryerson or Greg Weber.

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INTERNATIONAL NETWORK OF M&A PARTNERS

The International Network of M&A Partners (IMAP) is an exclusive global partnership of leading Merger & Acquisition advisory firms. Formed in 1971, IMAP unites a select group of professional organizations active in international transactions into a seamless global partnership. Each member firm shares a mutual commitment to delivering the highest caliber advisory services for middle-market transactions across the globe. IMAP advisers provide strategic merger, acquisition, divestiture and related corporate finance services. Sellers of mid-size companies and corporate acquirers alike rely upon IMAP for essential local market knowledge and industry expertise delivered with unparalleled global reach. Through their global partnership, IMAP firms are able to access strategic buyers, merger candidates and financial resources around the world to deliver exceptional results for their clients.



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