Home Care Partnerships, M&A, and Valuations

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**Objective**

Address Owner’s perspective about Selling, Merging, and Valuing their Business.

- In a comprehensive, easily understandable manner while...
- Incorporating the process of getting the deal done.
Some Points Covered Today

1. Look for the right buyers/partners for your situation.
2. Use the M&A process to your advantage.
3. Rules of thumb regarding “Price” for the company.
5. Single Offer versus Auctions.
6. Don’t confuse “Price” and “Value.”
7. Other Pitfalls and Considerations

M&A Process, Step by Step

1. Identify prospective buyers.
2. Prepare the confidential information memorandum and acquisition profile (teaser).
3. Distribute the acquisition profile to prospective buyers.
4. Secure non-disclosure agreements (NDA) from interested buyers.
5. Distribute the confidential information memorandum (CIM).
6. Conduct meetings and negotiations.
7. Deal is cut: Secure a letter of intent.
8. Buyer conducts due diligence.
9. Deal is finalized: Negotiate and prepare the definitive agreement.
10. Closing.
### M&A Deal Drivers

<table>
<thead>
<tr>
<th><strong>Buy Side</strong></th>
<th><strong>Sell Side</strong></th>
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</thead>
<tbody>
<tr>
<td>Growth strategies (Strategic buyers)</td>
<td>Baby-boomers (Aging out or umbrella drink exits)</td>
</tr>
<tr>
<td>Private Equity (Financial buyers)</td>
<td>Serial entrepreneurs (Moving on to the next thing)</td>
</tr>
<tr>
<td>Uncertain economy and pent-up deals</td>
<td>Use M&amp;A to raise capital and expand</td>
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<tr>
<td>Short technology lifecycles</td>
<td>Record valuations and multiples in select industries - a shifting phenomena</td>
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<tr>
<td>Roll-ups (limited since the late 90s)</td>
<td>Distressed situations</td>
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### Buyer Types

**Drive Business Value (in Part)**

<table>
<thead>
<tr>
<th>Buyer Type</th>
<th>Seeks To Generate Value Through</th>
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<tbody>
<tr>
<td>Industry consolidators</td>
<td>Operational means (expansion, economies of scale, market share, etc.)</td>
</tr>
<tr>
<td>Private equity groups/Financial buyers</td>
<td>Financial engineering and operational efficiencies</td>
</tr>
<tr>
<td>Industry (non-strategic)</td>
<td>Bottom-fishers (opportunistic)</td>
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<tr>
<td>Individual buyers</td>
<td>One-offs</td>
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<tr>
<td>ESOPs &amp; Management Buy Outs</td>
<td>Inside buyers - long-term strategy</td>
</tr>
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</table>
Introducing the Buyers

- **US Financial Buyers**: 25% - 30%
- **US Strategic Buyers**: 40% - 51%
- **Foreign Buyers**: 25% - 30%

*Source: Mergerstat Review*

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Private Equity Groups

- 8,000+ in operation
- Rapidly-growing sector
- Target ongoing businesses
- Have acquired thousands of companies to generate price and growth arbitrage
- Control $1 Trillion in “impatient money”
- Aggressively seeking investment opportunities
Eight Jewels of M&A Value

1. Valuation methodology: using the right approaches and using them correctly
2. Earnings: past or future
3. Earnings multiples: reflect growth rates, buyer requirements, negotiation skills and the dynamic marketplace
4. Balance sheet, working capital and enterprise value: a second look at value
5. The six buyer types: a major factor in determining value
6. Target company’s values and negatives: it’s not just about multiples
7. Negotiation and staging: when all is said and done, this is where value is derived
8. Consideration: it’s not about the price: it’s about the consideration mix

M&A Valuation Approaches

• Preliminary expert value in the marketplace: just a frame of reference
• Strategic value: beauty is in the eye of the beholder(s)
• Transaction value: the actual deal that takes place
• Formal appraisals (FMV): Important to judges and lawyers in court rooms for legal purposes
Principal Valuation Methodologies

1. Asset appraisal method (unusual/liquidation)
2. Income (EBIT-DA) methods (earnings multiple)
3. Marketplace methods:
   a) M&A method (actual, comparable deals)
   b) Public company guideline methods (compare to publicly-traded companies)
4. Guessing methods

Buyers Buy: (EBITDA) Pre-Tax, Pre-Interest Income or Cash Flow

• **What?** Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)

• **Why?** Buyers and sellers consider EBITDA a proxy or close approximation to cash flow, and

• **Who cares?** Buyers care because cash flow comparisons allow them to evaluate alternative investment vehicles that provide cash flows.
  - Bonds 5%
  - Real estate (commercial) 8% to 11%
  - Large cap stocks 10%
  - Small cap stocks 16%
Buyers Buy *Future* Earnings
Which Can Only Be Estimated Usually With Reference to One of the Following

- Last 12 months earnings plus a short-term growth rate supported by reasonable facts and assumptions. (*backlogs, pipelines, etc.*)
- Average of some past periods (only cyclical businesses)
- Pure projection of future periods (start-up businesses)

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**Conducting a Preliminary Valuation**

1. Determine pre-tax net income (cash flow) (EBITDA).
2. Normalize cash flow to (EBITDA).
3. Determine a multiple of EBITDA by reviewing actual, comparable deals.
4. Determine the value of the business’ income by multiplying number 2 by number 3.
5. Examine the balance sheet to identify additional value.
6. Add number 4 to number 5.
Normalize Earnings to Establish “Real” EBITDA or Pre-tax Cash Flow

**Reported net taxable income**

$ 500,000

**Adjustments:**

- Add back owner salary > $150K $ 650,000
- Add back interest on long-term debt $ 50,000
- Add non-recurring expenses $ 250,000
- Add back depreciation $ 50,000

**Normalized/Re-cast net (EBITDA)**

$ 1,500,000

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**Rules of Five and Ten**

Understanding transaction valuation with a handy Rule of Thumb

- Majority of companies and transactions:
  - Rule of 10
  - Rule of 5
Multiples are Just a Shorthand Convention

“Return on Investment” (ROI) is what we are really talking about BUT it can easily be expressed as a multiple:

• 20% = 5X

<table>
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<tr>
<th>Rule of:</th>
<th>$5,000,000</th>
<th>Revenue</th>
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<td>10%</td>
<td>$500,000</td>
<td>EBITDA</td>
</tr>
<tr>
<td>5</td>
<td>$2,500,000</td>
<td>Sale price</td>
</tr>
<tr>
<td>20% ROI</td>
<td></td>
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• 25% = 4X

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Super Rule of Five

Multiples Exceeding 5x Trailing Earnings Generally Require:

- Growth rate justification
- Synergies justification
- May be justifiable in *hot industries with high growth rates*
Enterprise Value and The Balance Sheet
Sometimes a confusing concept but critical to understand:
(Who Gets What?)

Buyer gets the (necessary) balance sheet except:
• Assumes a cash-free (usually), long-term debt-free company
• Unnecessary assets may be retained by seller and/or sold to buyer for additional consideration

Value of a Specific Target

• Revenue stability and visibility is crucial
• Problems arise when buyers find:
  – Customer concentration
  – Obsolescence
  – Cyclicality
  – Professional goodwill/key management dependence
Larger Companies: Greater Stability Yields Higher Prices

<table>
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<tr>
<th>Annual Revenue</th>
<th>Number of Transactions*</th>
<th>Median Multiples</th>
</tr>
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<tbody>
<tr>
<td>$50 million</td>
<td>15</td>
<td>7.5</td>
</tr>
<tr>
<td>$20-$50 million</td>
<td>28</td>
<td>7.4</td>
</tr>
<tr>
<td>$10-$50 million</td>
<td>37</td>
<td>6.6</td>
</tr>
<tr>
<td>&lt; $10 million</td>
<td>41</td>
<td>5.4</td>
</tr>
<tr>
<td>Total</td>
<td>121</td>
<td></td>
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When to Sell or Merge

- Perennial cycles
- Irony: businesses sometimes are more valuable when they are smaller
- Economic cycles and personal cycles: Do the two coincide?
- Future cycles: Will they be the same?
Timing the Deal or Waiting for Next Year’s Growth: A Potential Costly Trap

Approaching Larger Company Buyers

Understand the pecking order and entry points:

- Unit executives are deal champions, and
- M&A personnel and/or corporate development officers are often number crunchers
Confidential Information Memorandum

• Preliminary due diligence document
• Sales document
• Communicates opportunities vs. weaknesses

*(Don’t hide problems or issues!)*

The Letter of Intent

• Executed to keep the deal moving with the least amount of disruption
• Must be thorough
• Binding in only two regards
Don’t Hide Problems/Issues
Letters of Intent Are Not Invitations to Further Negotiation

The Seller's Advantage Curve

Seller

Buyer

Management Presentation  Multiple Offers  LOI Negotiations  Exclusivity to Buyer  Closing

Investment Banker
A simple but important definition

Should be a highly trained and highly experienced individual in the capitalization, sale or acquisitions of business entities.

Training usually includes heavy doses of deal structuring, finance, valuation, accounting, securities laws, commercial law and especially negotiation techniques and staging.

Their team has probably done hundreds of transactions. Try to avoid reinventing the wheel or outguessing them.
Properly Leveraging the Negotiation Team

- **Investment Banker** - direct negotiator for business terms
- **Attorney** - direct negotiator for legal terms
- **Client** - shadow negotiator for all terms

1. **DO NOT CONFUSE TEAM MEMBERS OR THE ROLES THEY PLAY**
2. **AVOID END RUNS**

Underlying Causes of the Dreaded End Run

- Not understanding that every deal dies 1,000 deaths before it’s finally closed
- Close correlation to the above: misunderstanding the process
- Sellers who force their way in contrast with their advisors
- Sellers assuming that, “If we can just sit down with the other side, we can work something out”
- Mr. Nice Guys who cannot say “no”
- Stressed-out clients

Whatever the cause – the dreaded dead-end is almost always fatal.
Negotiation Functions of an M&A Investment Banker

- Conducts preliminary valuation/research
- Speeds the process (exponentially)
- Shelters principals from emotional deal-killers and poor future relations
- Provides deep frame of reference in art and science of deal-making
- Provides professional negotiation skills
- Capitalizes on the buyer’s fear of auctions
- Realizes substantially greater values in the end

The Auction & Negotiation Staging

**Timing of buyer proposals:**
- Have multiple buyers
- Time them to activate simultaneously
- Negotiate independently and simultaneously
- Consider controlled auction if big enough

**Dialogue with buyers:**
- Be ingenious. **Don’t price the company** but do discuss market/consideration/process
- Opportunity vs. weakness
- Never underestimate your own position
Effective Auctions: Don’t Assume The “Likely” Identity of the Buyer

![Pie chart showing 30 Recent Transactions: 87% (No) and 13% (Yes). Source: Goldsmith Agio Helms]

M&A Consideration: Types and Ranges

Principle elements:

- **Cash**: usually around 80% to 90%
- **Seller take-back notes**: rare but if any, then 20% to 40%
- **Stock**: rare but if any, then 20% to 80%
- **Earn-outs**: i.e. contingent consideration
  - If any, then 15% to 25% contingent
  - Comfort vs. incentive earn-outs
When Taking Stock: *Caveat Emptor!*

**Public company stock:**
- SEC Rule 144
- Dribble rules
- Investment considerations

**Private company stock:**
- Minority stock rights
- Liquidity guarantees and puts

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**Price vs. Terms**

“A cynic is a person who knows the price of everything and the value of nothing.”

- Oscar Wilde -
Consideration (Terms) vs. Price

- Terms drive the deal, *not price*

- Key negotiation technique: your price, my terms and seller/buyer egos

Deal Terms, *Not Price*, Determine Value

Real issue for buyers:
- Is it a good platform from which to build?

Real issue for sellers:
- Certainty of collection & time/value of (net) money at the end of the day.
The Earn-Out

- Comfort earn-out: bridges the comfort gap
- Incentive earn-out: offers an opportunity for a double dip
- Negotiation Points:
  A. Proof period of one year to three years
  B. Control is with whom?
  C. Legal or effective control
  D. Bottom, top or middle measurements
  E. Floor and ceiling for earn-out amounts
  F. Cumulative targets?

Tax Issues & Structuring Considerations

- C Corporations (stock deals only)
- S Corporations (may be either stock or asset)
- Partnerships and LLCs (no real problems)
- Installment sale effect (great opportunity)
- Tax-free exchanges: all stock or no more than 50% cash - reorganizations
- Write-off elections
The Top 14 Seller Mistakes

1. Selling without representation
2. Selling to a single offeror
3. Poorly constructed earn-out
4. Disclosing an insufficient amount of information in Offering Memo
5. LOI not thorough
6. Focusing on history and numbers instead of future opportunity
7. Mismanaging team, end runs
8. Representation by an unlicensed broker
9. Communicating your asking price inappropriately
10. Eliminating offshore buyers
11. Assuming the type of buyer
12. Waiting until management is ready to retire
13. Waiting for next year’s growth
14. Ignoring or over-emphasizing timing

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