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Executing a Successful Liquidity Event

Preparing to Capitalize on an Improved Market

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The liquidity markets are far more active than even just a year ago. While the challenges in executing the Facebook initial public offering have dulled the IPO market, private equity and strategic buyers are vigorously pursuing growth vehicles. Reasons for the increased availability of capital include: a return of the debt markets, potential changes to capital gains tax rules, and the need for private equity to put to work capital dormant during the recession.

As a result, well-positioned companies have greater access to the equity markets as a means to drive growth than they have had since 2006. For most entrepreneurs, however, the liquidity process remains confusing. In 2011, J.H. Cohn's first forum titled "Position Your Company for a Liquidity Event" helped management determine if a liquidity event was a good option for them and to stress the importance of leadership and proper planning as the keys to liquidity event success.

Our View of the News

Companies seeking growth capital are finding an attractive market. To realize that capital, however, entrepreneurs must take a structured approach toward selecting advisors and preparing for equity partners.

At this year's event, panel members included specialists in the consumer products, manufacturing, hospitality, and technology sectors from some of the nation's leading investment banking and private equity groups as well as CEOs who are veterans of the liquidity process. Building on the strategies discussed in 2011, the panels focused on executing the liquidity process. Three themes emerged:

Opening Remarks: Steven Mayer, CPA, J.H. Cohn, regional managing partner—New York

Let Your Strategic Goals Dictate Your Equity Partner

Picking a partner can be daunting, and a good banker can help, but management must keep strategic priorities in mind. If looking for a second bite of the apple, for example, consider which partner will best help management increase the value of the company rather than the one offering the highest price.

The Process Is Heavily Relationship-Driven

Sure, the numbers have to work but the liquidity process requires the banker, financial sponsor, and management team to work closely together. Executives felt strongly that "dating" bankers prior to a potential transaction helped determine banker selection and market timing. Management and private equity groups stressed the importance of getting to know one another to build mutual credibility and trust.

Preparedness Is Key to Easing Due Diligence Pain

No one is prepared for due diligence the first time. Entrepreneurs focused on growing the business are often less focused on maintaining books and records. Because everything will be scrutinized, retain a lawyer and accountant to review financial and operating records and clean up outstanding issues. Restrictions imposed by earlier financings may be a red flag.

Using an Investment Bank to Broker a Transaction

Investment bankers play a critical role in properly executing a liquidity transaction. They assist management teams in preparing the company for sale, conduct analyses to assist in valuing the company, and execute a process to identify buyers—both financial sponsors and potential strategic buyers. The environment for liquidity transactions is as good as it has been in five years. The debt markets are providing good leverage and capital is available at fairly low cost compared to historical norms. Growth companies with strong economics and strong brands are achieving impressive multipliers. Deals for slower growth companies "without all the boxes checked" are getting done too.

Moderator: Lou Pizzileo, CPA, J.H. Cohn, partner and co-director of Technology and Life Sciences Industry Practice

One trend that may be accelerated by the JOBS Act is a dual-track process that typically involves filing for an IPO. But, while the company is going through the SEC process, they also are talking to potential private equity and strategic buyers. There is significant overlap in documentation and due diligence, so there can be synergies to employing a dual-track process, plus it allows you to run side-by-side valuations to determine the best course of action. Going dual track is an intensive process, however, and management can be overwhelmed by due diligence responsibilities.

To discuss the role investment bankers play in the liquidity process, J.H. Cohn convened a panel of experts, led by the Firm's Technology and Life Sciences Industry Practice co-director, Lou Pizzileo, CPA.

Q: When is the right time to involve an investment bank in the liquidity process?

GEOFF: Engage advisors earlier than you might think. You're not hiring a firm, you're hiring a team of individuals. My best relationships are ones where I've known the management team for several years before getting hired. That way they know how I think and act and vice versa. They have time to build credibility with me.

MURRAY: A couple of years is ideal. It can take six months to get a deal done and six months to properly prepare for a deal, so hopefully you're meeting and putting your advisors into place the year before that.

Panel 1: Utilizing Investment Banks to Help Raise Liquidity

Geoff Flynn, Cowen and Company, managing director and head of Consumer Investment Banking Group

Murray Huneke, Piper Jaffray, managing director and head of Consumer Investment Banking

Matthew Kelly, North Point Advisors, partner and managing director

My best relationships are ones where I've known the management team for several years before getting hired. That way they know how I think and act and vice versa. Geoff Flynn

Q: What criteria should management be considering when shopping for an advisor?

MATT: Start with the basics. Look for someone who gets deals done, who does a high volume, and who delivers the right valuations. Integrity matters, so make sure to talk to a number of references. Ours is a referral driven business. You've got to hear good things about potential advisors before committing to them. On the topic of advisors, finding the right accounting and law firms is equally important. You need to get sound advice from all sectors throughout the process.

Key Takeaways

- With good leverage in the debt markets, capital is being put to work at historically low return levels.
- The confidentiality of the JOBS Act IPO registration process may increase the use of dual-track processes, allowing entrepreneurs to conduct side-by-side valuations.
- Start the liquidity process two years in advance by selecting advisors who can best help you achieve your strategic objectives.

GEOFF: The point person on your advisory team needs to truly be your trusted advisor. These transactions are what we do for a living. There will be times during the process where you will need to rely on the insight and experience of your advisor. This may be the most important transaction of your lifetime, so it is critical that you pick someone with the expertise to earn your trust.

Q: How do you manage the expectations of the CEO who thinks the company is worth 11x and you know it is really worth 8x?

MATT: It is a slow, thoughtful education process. It is our job to help the CEO understand the range in which the valuation is likely to fall. We do this by looking at the precedents. We need to help them understand what returns the buyer is looking for and what returns their projections offer at different multiples. So, if the CEO is looking for an 11x multiple, you can help them examine earnings and projections and see that their expectations might not be realistic. The market will tell everyone what the business is worth.

Q: How do investment banks choose the clients they will work with?

GEOFF: We start by choosing to work with a management team that we like and respect. We'll work together closely, so we look for management that will really listen to our counsel, but will be thoughtful and push back when appropriate. We look for a good company, one that is well positioned in the marketplace so that the entire package of management and company will be attractive to the marketplace.

Start with the basics. Look for someone who gets deals done, who does a high volume, and who delivers the right valuations. Integrity matters, so make sure to talk to a number of references. Matthew Kelly

MURRAY: We start by narrowing companies to the industries that we really understand. Then, frankly, we pick deals that can get done. We work on a contingency basis—we don't get paid until the end of the transaction. We put a significant investment of time and effort into a transaction, so it is important that we don't commit resources to deals that we don't think we can get done.

Q: What decisions should owners of a growing company avoid that might hinder their ability to conduct a liquidity event?

MURRAY: Any early stage financing can hurt a later financing. This is where you need to rely on advice from a good attorney and accountant. These practices can vary sector-by-sector, but be alert for any super veto rights that early investors and limited partners might have over later deals.

GEOFF: We were engaged by an e-commerce company to do a capital raise and sell the company. They were thrilled to have a $5 million investment from a major internet commerce company. The investment came with a right of first refusal clause that provided blocking rights on everything. It significantly impacted the path the company could take. The growth capital was much needed and the company was excited by the investment, but they didn't think through how it would impact later financings and their exit strategy.

The other pitfall would be not having a history of budgeting appropriately and comparing actuals to budget. When you do a liquidity event, bankers and buyers will look at historical results in detail. If you budget on a quarterly basis, analyze how you performed retrospectively, and the reasons for variances to budget, it will not only help you immensely in planning and running your business, but also enable you to better respond to banker/buyer questions.

MATT: Maintaining good records is key. You need to know how much everything costs, otherwise it can be hard to prove what the returns actually are. This is also where having a good accounting firm can come into play. Being ready for due diligence means being prepared to answer these types of questions. The process takes four to six months because everyone is considering what can go wrong and they want to understand every aspect of the business.

About the JOBS Act

The Jumpstart Our Business Startups Act ("JOBS Act") may ultimately improve the ability of small and medium-sized enterprises ("SMEs") to launch initial public offerings and raise additional capital through private and public offerings. It raises the threshold for the point at which privately held companies are required to register with the Securities and Exchange Commission and incur the costs of periodic filings, and make it easier for smaller, non-public companies to raise capital through offerings exempt from SEC registration.

The bill creates a new category for issues called "emerging growth companies" that have annual revenues of less than $1 billion at the time of an IPO and a public float of less than $700 million. Emerging growth companies would enter a regulatory "on-ramp" period of up to five years during which they would be temporarily exempt from many of the financial control and reporting requirements of the Sarbanes-Oxley Act and various SEC registrations.

J.H. Cohn believes that capital, in all its forms, is the underpinning of job creation and that the U.S. needs to create a more efficient delivery system for SMEs to access the capital markets. This includes removing the friction that small companies experience when raising capital. Companies that qualify as an emerging growth company considering a liquidity event can confidentially submit an equity IPO registration statement for SEC staff review. They may permit SMEs to better conduct a dual process in executing a liquidity event.

We start by narrowing companies to the industries that we really understand. Then, frankly, we pick deals that can get done. Murray Huneke

Leveraging Private Equity's Financial and Intellectual Capital

Until the mid-2000's, the private equity market was thriving. Debt was readily available and there was a climate of doing deals because no one wanted to miss out on being in the market. Then came the recession and, almost overnight, lending dried-up and the flow of deals ceased. Today, lending is back and there are a large number of private equity groups with a need to put their capital to work.

The climate is one where the supply of good, investment grade companies is less than the demand to do deals with them. Private equity groups are choosier than before the recession, but deals for growth companies—those with excellent management teams, a good business model, and solid earnings—are receiving excellent valuations and multiples. This creates a high-class problem for companies looking to do deals. Picking the best deal means focusing on your strategic objectives. Founders who are looking to sell and walk away are finding plenty of available capital. Management looking to stay involved and take a second bite of the apple need to look for the right fit—someone with experience in the industry and the track record for adding value.

Private equity groups see a large number of businesses more intimately than management, so the potential to leverage their experience and intellectual capital is real. But, when looking for private equity groups that can assist in value creation, don't neglect your due diligence. Critically assess what they have done to add value to current and prior portfolio companies and ask what people they will bring to the deal that will make the business better, so you know what to expect.

Moderator: Gary Levy, CPA, J.H. Cohn, partner, Hospitality Industry Practice director and member of the Private Equity/Venture Capital Practice

How private equity groups are approaching the market today was the focus of "Structuring Successful Private Equity Deals," the second of three sessions at J.H. Cohn's annual event "Position Your Company for a Liquidity Event," which was moderated by Gary Levy, CPA, a J.H. Cohn partner, director of the Firm's Hospitality Industry Practice, and member of the Firm's Private Equity/Venture Capital Practice.

Panel 2: Structuring Successful Private Equity Deals

Richard Leonard, Angelo, Gordon & Co., member, Private Equity and Special Situations

Robert Landis, The Riverside Company, partner

Jonathan Owsley, Catterton Partners, partner

The culture developed by the entrepreneur and by the management team is a lot of what we are buying. Richard Leonard

Q: How much does private equity get involved in directing the business? How do you create value?

RICHARD: You're touching on one of the most important things for a business owner to keep in mind. We are not operators. The culture developed by the entrepreneur and by the management team is a lot of what we are buying. We can help you consider improvement options, but we're not the ones to execute. One of the fundamental questions management should have for a private equity firm is, how involved are you going to be in my business? Are you going to be an operating partner that has an office in my headquarters? Am I only going to talk to you every quarter or are we talking weekly? There are private equity groups that have been successful with the entire range of answers.

We work with successful former chief executives to help us evaluate an opportunity. They will sit on the board with us after the deal and act as a sounding board, mentor, and shoulder to lean on for the management team. They have expertise and experiences that the financial people don't have. At the same time, if we all recognize the needs of the organization before we invest—say your controller is a good controller, but we need a CFO—that's where we can utilize our resources to get involved and help.

Key Takeaways

- The supply of investment grade companies is currently less than the demand to do deals.
- Private equity partners won't operate the business, but they'll bring ideas for improvement driven by their industry expertise.
- Learn how advisors and potential buyers assess value. Understand the rationale that positions you as an outlier.

Q: What are your thoughts on control provisions? What are the red flags?

RICHARD: We are most interested in control situations. Control can be illusory, however. You don't want to run roughshod over management. Most private equity groups hate to fire the CEO. Most will also say that when they do it, they do it a year too late. We won't invest, however, if we don't think the management team can deliver.

ROBERT: If we're looking to buy into a company and the owner doesn't want to reinvest, that's a big red flag for us. We want owners that will have meaningful re-investment. We treat the founders' equity the same as private equity. We don't have A-shares and B-shares. Management should ask what happens if you reinvest and the business excels. Do you get options for performance? Make sure you understand your incentive to grow the company.

If we're looking to buy into a company and the owner doesn't want to reinvest, that's a big red flag for us. We want owners that will have meaningful re-investment.
Robert Landis

Q: What criteria do private equity groups have for monetizing their investment?

ROBERT: Our goal is to triple sales and EBITDA. We look at EBITDA inflection points, for example at $10 million, $30 million, and $50 million, because at those points you tend to get another multiple as companies establish more robust earnings. Those points are set according to the size of the funds making the investment and the kind of financing one can get.

RICHARD: There isn't a rule-of-thumb. The decision is different for every firm. It is also different as to whether the investment is the first investment in a fund, in which case there will be more patience, or the last investment, where there may be pressure from the investors. In general, I believe that if you take care of the company, the exit will take care of itself.

Where you run into differences of opinion is if you have held the investment for five to seven years and there is an opportunity for reinvestment, such as building a new factory, making an acquisition, or entering a new market. You may get situations where the management team is saying, "Let's do this one more thing and then we can exit." That's a high-class problem because we can introduce management to an investment bank who can run a process and tell that story to potential buyers who are interested in hearing about the future growth. We have to go into an investment with the knowledge that eventually we will need to liquify that investment.

Valuation in the Liquidity Process

As Warren Buffet famously said, "Price is what you pay. Value is what you get." While Buffet was referring to the stock market, his statement equally applies to the liquidity event valuation process. When looking for advisors, all factors being equal, a higher valuation (i.e., higher price) is certainly better. Rarely, if ever, however are all the factors impacting the value offered by different advisors equal. Choosing the best partner requires management to understand the underpinnings of the valuation process and assess the intellectual capital that potential equity partners bring to the table.

When valuing a company, potential buyers and investors take a multitude of factors into consideration, including cash flow, earnings growth, and the number of debt turns. Each buyer has their own model, their own approach to determining value, so investment bankers look at precedents, or other deals that have been done and the multiples at which those deals were executed, in order to best advise clients.

When dissatisfied with the process, management often indicates that a difference in expectations of the company's value was the reason. The cost from a time, energy, and money perspective to start and execute a process is incredibly high, so management should understand how buyers or investors are going to approach value. When talking to potential advisors, make sure they're not just telling you what you want to hear. If most deals are getting done at 8x EBITDA and someone is telling you that you can get 9.25x, make sure you understand why you are an outlier. Push them on their methodology toward assessing value. Checking references can go a long way toward verifying an advisor's credibility and their approach to assessing value and creating long-term relationships.

The Leadership Perspective on Doing a Deal

There are many factors to consider when contemplating a liquidity event, including analyzing how the equity investment helps the company achieve its strategic objectives, determining the nature of the transaction, and assessing how to properly time the market. Conditions in this post-recessionary period are favorable to executing deals, but what is the process really like and what can management do to put the business in the best position to take advantage of the market?

Christopher G. Aroh, CPA, J.H. Cohn, partner and member of the Firm's Private Equity/ Venture Capital Practice

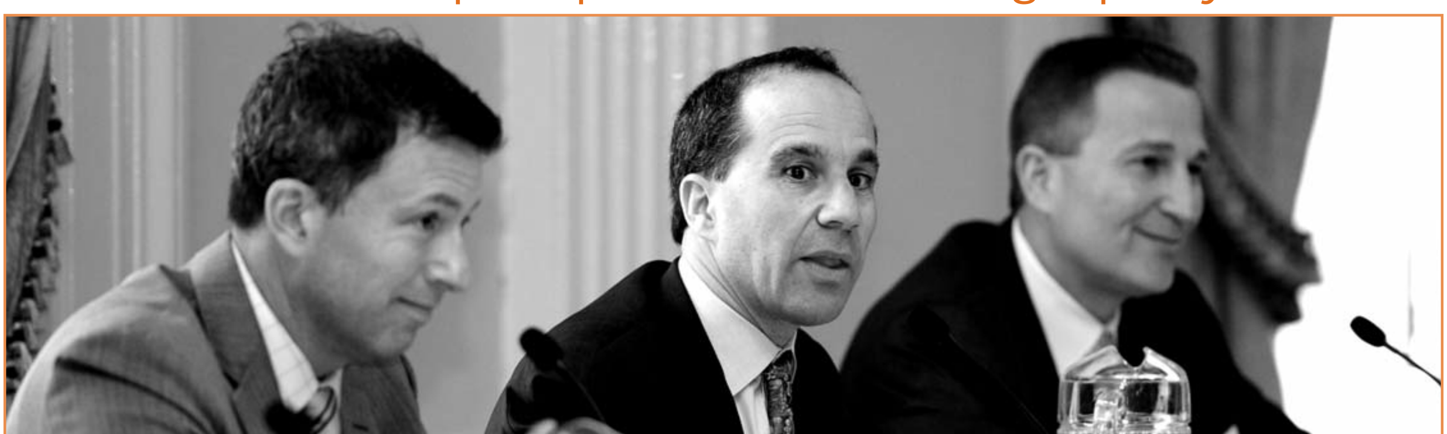
It's been said that the two most common refrains to management about the liquidity process are: don't take your eye off the business, and prepare to add 50 more hours to your weekly work schedule. While that guidance may be partially true, executives typically find that relying on a core team of advisors can make all the difference. Accounting and legal professionals experienced in supporting liquidity events can scrutinize records and controls to ease the burden of the due diligence process and the right investment bank can help management identify the right partners to achieve their objectives.

J.H. Cohn partner Christopher Aroh, CPA, a member of the Firm's Private Equity/Venture Capital Practice, led a discussion with current and past chief executive officers who piloted their companies through the liquidity process.

Q: Having successfully executed one or more liquidity events, what did you learn about the process that would benefit executives considering an event today?

MARC S.: I think of the process of finding a partner as a funnel. You start by finding an investment bank with which you have a strong rapport and want to work. You will spend a ton of time with these bankers, so you want to go through a "dating period" to get to know them. You will work with them to whittle down the vast universe of potential acquirers, which could be as large as 300. You might select ten different groups with which to interview. During that period you'll need to

Panel 3: The Leadership Perspective on Maximizing Liquidity and Value



Mark Fasciano, Canrock Ventures, managing director	**Andy Pforzheimer, Barteca Restaurants, LLC,** CEO	**Marc Sculler, Bell'O International,** CEO

What I found important was to build relationships with investment bankers to determine market trends. They're talking to many more buyers than you'll ever be able to speak with. Mark Fasciano

determine which ones you can work with and whether they share the same strategic goals you have with regards to top-line and bottom-line growth.

ANDY: It is a much more relationship-driven process than I thought. The deal starts and ends with the numbers, but the growth period is about relationships and people. You're going to spend five to seven years with your investors, so you've got to like them. You have to agree as to how you're going to get to the end game. In our case, we wanted to retain significant equity and a lot of say. We knew how to run the business well, but didn't know how to handle the exit. So we needed a partner who accepted how our equity was treated and how our operation was run. These are personal conversations. Some items I thought would be tough to bring up, almost embarrassing, including how much do we get paid, wound up being central to the conversation. I thought the process would be a bloodless, numbers game, but it ends up being a very personal six month long conversation.

MARK F.: Whether you are raising capital or looking to exit, the time that it takes to determine the market for your company is significant. If you are busy building your business, it is hard to carve out that time. What I found important was to build relationships with investment bankers to determine market trends. They're talking to many more buyers than you'll ever be able to speak with. Seeing what they found interesting in my story was crucial. Then at a certain point, it became obvious that it was time to pair up. I probably spent five percent of my time, before we were looking for any liquidity, keeping in touch with bankers in order to figure out when the time was right.

Q: How did you make the decision of selecting a partner?

MARC S.: We narrowed our selection down to seven to ten firms that we interviewed. A good investment banker will do much of the whittling down for you. It is a drawn out process and your first focus must remain on growing the business. A few of the ten stood out; they were in the highest quartile of offering price. Then it was about choosing the one that we felt we could work with the best. It wasn't the firm offering the absolute highest value.

Key Takeaways

- Utilize accounting and legal advisors to scrutinize records and internal controls in preparation for the due diligence process.
- If the liquidity event is not an exit strategy, select an equity partner that you truly like. You're going to spend five to seven years with them.
- After the event you'll be under the microscope with lenders and equity partners and have external board members with significant business expertise.

ANDY: We spoke to a half dozen firms and actually scored them. We put the most weight not on who was paying the most money now, but on who we felt would make the most money for us five years from now by best helping us grow. If we were cashing out, we might have taken a different approach. We also

It is a much more relationship-driven process than I thought. The deal starts and ends with the numbers, but the growth period is about relationships and people. Andy Pforzheimer

The first time through the due diligence process, no one is fully prepared. Maintaining a document file that you have easy access to is probably the best thing you can do.
Marc Sculler

looked for someone who was comfortable with our control provisions as large shareholders. We wanted someone with whom we'd still be smiling several years down the road.

Q: What happened after the close that was a surprise to you?

MARC S.: The most critical period is the first 12 months. Your business is leveraged now and you are somewhat under the microscope with your lenders and equity partners. Things don't always go as planned and it is during this time that you can either earn respect or potentially lose respect and credibility. There was a significant internal pressure that I hadn't felt before and didn't expect.

MARK F.: The biggest surprise was that I now had a real board of directors. I had never run or participated in a real board with outside directors. I learned that running good board meetings is crucial, but that it takes years of practice. I would advise chief executives considering a liquidity event to get on at least one external board to see how they work and how to run them effectively.

Q: With regards to the due diligence process, what were you well prepared for and what were you ill prepared for?

MARC S.: The first time through the due diligence process, no one is fully prepared. The diligence process comes from all angles—your investor and sometimes multiple lenders. The initial key is having a solid accounting firm and audited financial statements that form the backbone of your credibility. Then what you learn is that every contract, every document, every settlement and lawsuit, vendor agreements, confidentiality agreements, and so on come under review. Maintaining a document file that you have easy access to is probably the best thing you can do. This will get you three-quarters of the way there, but it is still a very tortuous process.

ANDY: The due diligence process was very painful. If I had to do it again, I would have been more diligent in managing paperwork and in holding on to all contracts. Unfortunately, in the middle of running the business, this isn't something that entrepreneurs are paying as much attention to as they should. In my case, my lawyer had to reconstruct the document record for 15 years of the business. My advice is that if you're looking at a liquidity event in a few years, now is the time to examine everything. Look at all your major agreements. Go back to investors and banks to potentially renegotiate terms. If you have anything open-ended, especially with investors whose terms are not crystal clear, clean it up. If there is anything sloppy or half-way done, it will come out and have to be dealt with. Get a good lawyer to comb through everything, look for gaps, and clean them up. ■

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One of the leading accounting and consulting firms in the United States, J.H. Cohn LLP specializes in audit, accounting, tax, and business consulting services for public and private companies, small and mid-size private equity and venture capital firms, and not-for-profit organizations. Since 1919, the Firm's philosophy has remained constant: to provide a highly personalized approach to each client, with intelligent guidance and solutions driven by technical and industry expertise that positively affect client profitability and growth. J.H. Cohn has cultivated a reputation for strategic insight, proactive leadership, unwavering integrity, and a genuine concern for clients and their businesses.

To help clients think and act across national boundaries, J.H. Cohn is an independent member of Nexia International, a global network of independent accountancy, tax, and business advisors and the tenth largest provider of audit and advisory services worldwide. The Firm has offices in New York, New Jersey, Connecticut, Massachusetts, and California. For more information, visit our website at www.jhcohn.com.

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