M&A ROADMAP FOR SUCCESS AND PREPAREDNESS

Moderator: Christine Williamson, CPA, Partner, CohnReznick

Speakers:
Greg Woodford, Senior Managing Director, The McLean Group
Jeffrey Michelson, Managing Director, CPA, CohnReznick
David Kuhnsman, Member, Protorae Law

January 13 and 14, 2020
AGENDA

• M&A Process Overview, Stages, and Timing
• Quality of Earnings & Working Capital
• Letter of Intent
• Best Practices & Lessons Learned
• Deal Examples with Significant due diligence challenges
• Q&A (please ask throughout)
M&A PROCESS OVERVIEW

Process Steps and Timing

A typical sell side transaction process can be broadly categorized into the following phases:

1. Pre-Market Preparation  
   - Weeks 1 - 6

2. Marketing - Outreach  
   - Weeks 7 - 11

2. Marketing - LOI  
   - Weeks 12 - 16

3. Diligence / Close  
   - Weeks 17 - 24

"Two-Step"

A typical sell-side process takes 5-7 months from start until closing. In some instances, competitive and market dynamics can expedite or lengthen this timeline.
1

PRE-MARKET PREPARATION

M&A Process - Preparation

CRITICAL STEPS

→ Assemble Deal Team
→ Determine Shareholder Objectives
→ Establish Market / Process Timing
→ Perform Initial Due Diligence
→ Create Marketing Materials

RELEVANT COMMENTARY

- Organize your deal team – management, banker, lawyer, accountant, etc.
- Discuss valuation, structure, timing, confidentiality, and transition / culture
- Develop a process timeline tailored to business and market-specific dynamics
- Diligence potential areas of risk including Quality of Earnings and other Financial data needs
- Craft market positioning strategy and begin drafting marketing materials

CRITICAL DELIVERABLES

→ Contract Waterfall
→ Pipeline / Financial Projections
→ Confidential Information Memorandum (CIM)
→ Buyers List
→ Teaser
→ Non-Disclosure Agreement (NDA)

RELEVANT COMMENTARY

- Use existing contract data / backlog as foundation for future projections
- Develop projections based on probability-weighted new business opportunities
- Create a comprehensive memorandum that highlights all facets of the business
- Compile a categorized list of strategic and financial buyers to contact
- Anonymous one-page document used to solicit initial buyer interest
- Work with legal team to create NDA template to share with interested parties
## MARKETING PHASES 1 & 2

### M&A Process - Outreach / LOI

<table>
<thead>
<tr>
<th>CRITICAL STEPS</th>
<th>RELEVANT COMMENTARY</th>
</tr>
</thead>
<tbody>
<tr>
<td>→ Commence Buyer Outreach</td>
<td>- Negotiate NDAs and send teasers and CIMs to parties included on buyers list</td>
</tr>
<tr>
<td>→ Assemble Virtual Data Room (VDR)</td>
<td>- Consolidation of all relevant company information to be provided in diligence</td>
</tr>
<tr>
<td>→ Solicit Indications of Interest (IOIs)</td>
<td>- Initial buyer proposals that outline a purchase price range and relevant detail</td>
</tr>
<tr>
<td>→ Hold Management Presentations</td>
<td>- One-on-one meetings between priority buyers and the seller</td>
</tr>
<tr>
<td>→ Solicit Letters of Intent (LOIs)</td>
<td>- Final proposal that provides a definitive purchase price consideration, deal structure / financing, primary diligence expectations, and exclusivity timing</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>CRITICAL DELIVERABLES</th>
<th>RELEVANT COMMENTARY</th>
</tr>
</thead>
<tbody>
<tr>
<td>→ Non-Disclosure Agreements (NDAs)</td>
<td>- Negotiate “redlines” with buyer and correspond with legal counsel as needed</td>
</tr>
<tr>
<td>→ Marketing Updates</td>
<td>- Status report that summarizes where contacted parties stand in the process</td>
</tr>
<tr>
<td>→ Virtual Data Room</td>
<td>- Collect and organize relevant company data and perform analytics as needed</td>
</tr>
<tr>
<td>→ Indications of Interest Summary</td>
<td>- Summarize initial bid terms in a presentation to discuss with management</td>
</tr>
<tr>
<td>→ Management Presentation</td>
<td>- Create a presentation to reference during meetings with priority buyers</td>
</tr>
<tr>
<td>→ Letters of Intent Summary</td>
<td>- Summarize final bid terms in a presentation to discuss with management</td>
</tr>
</tbody>
</table>
DILIGENCE AND CLOSE
M&A Process - Confirmatory Diligence & Closing

CRITICAL STEPS
→ Execute Letter of Intent
→ Establish Diligence Responsibilities
→ Maintain Diligence Streams in Parallel
→ Compile Legal Disclosure Schedules
→ Negotiate Purchase Agreement Terms

CRITICAL DELIVERABLES
→ Letter of Intent
→ Working Group List (WGL)
→ Due Diligence Request Tracker(s)
→ Draft Purchase Agreement (Asset / Stock)
→ Legal Disclosure Schedules
→ Fully Executed Purchase Agreement

RELEVANT COMMENTARY

CRITICAL STEPS
- Negotiate key transaction terms in LOI to establish precedents for diligence
- Identify key management personnel to collaborate with on data requests
- Effectively manage all diligence correspondence / logistics to maintain timeline
- Seller management to compile data exhibits to reflect in purchase agreement
- Collaborate with seller legal counsel to preserve shareholder value through mitigation of transaction risk within the confines of the purchase agreement

CRITICAL DELIVERABLES
- Establishes final purchase price / structure and key exclusivity expectations
- Compile relevant contact information for all diligence parties
- Comprehensive tracking method for maintaining all diligence requests
- Buyer-provided “first-pass” at memorializing all transaction contract terms
- Supplements “representations and warranties” within the purchase agreement
- Signed definitive agreement that formally memorializes the transaction just prior to “releasing the wires” that fund the transaction closing
Market and business dynamics can influence a buyer's assessment of strategic value - Sellers who can successfully position unique qualities in today's market will be more likely to entertain higher valuations.

<table>
<thead>
<tr>
<th>COMPONENTS OF ENTERPRISE VALUE</th>
<th>VALUE DRIVERS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>MARKET FORCES</strong></td>
<td>▪ Federal budget and spending dynamics</td>
</tr>
<tr>
<td></td>
<td>▪ Political factors</td>
</tr>
<tr>
<td></td>
<td>▪ Public market valuations</td>
</tr>
<tr>
<td></td>
<td>▪ Economic and market performance</td>
</tr>
<tr>
<td></td>
<td>▪ Interest rates</td>
</tr>
<tr>
<td><strong>SALABILITY OF CONTRACT BASE</strong></td>
<td>▪ Contract award basis (FO, SB, 8a, SDVOSB)</td>
</tr>
<tr>
<td></td>
<td>▪ Contract role (Prime / Sub)</td>
</tr>
<tr>
<td></td>
<td>▪ Backlog</td>
</tr>
<tr>
<td></td>
<td>▪ Recompete profile</td>
</tr>
<tr>
<td><strong>CORE BUSINESS FUNDAMENTALS</strong></td>
<td>▪ Financial profile / size</td>
</tr>
<tr>
<td></td>
<td>▪ Management quality - depth &amp; breadth</td>
</tr>
<tr>
<td></td>
<td>▪ Customer mix</td>
</tr>
<tr>
<td></td>
<td>▪ Capabilities</td>
</tr>
<tr>
<td></td>
<td>▪ Addressable market</td>
</tr>
<tr>
<td><strong>SPECIALIZATION / DIFFERENTIATION</strong></td>
<td>▪ Proprietary technology - IP</td>
</tr>
<tr>
<td></td>
<td>▪ Business model - product vs services</td>
</tr>
<tr>
<td></td>
<td>▪ Contract vehicles</td>
</tr>
<tr>
<td></td>
<td>▪ Alignment with funding priorities</td>
</tr>
</tbody>
</table>
Today's valuation environment is arguably at a 10 year high in the government contracting industry. However, it is critical for business owners to candidly assess their business (and have experts do the same) so they understand how the market with value their company when they decide to sell.

### In rare cases, companies that exhibit highly differentiated traits can 'sell through' salability concerns and garner higher valuations

<table>
<thead>
<tr>
<th>Companies with Salability Concerns</th>
<th>3x</th>
<th>5x</th>
<th>7x+</th>
</tr>
</thead>
<tbody>
<tr>
<td>Companies without Salability Concerns</td>
<td>6x</td>
<td>8x</td>
<td></td>
</tr>
<tr>
<td>Highly Differentiated Companies</td>
<td>10x</td>
<td>12x+</td>
<td></td>
</tr>
</tbody>
</table>

### Drivers and Impact within the Above Ranges

- **Sub**
- **POSITIONING**: Prime
- **Set-Aside**
- **AWARD TYPE**: Full & Open
- **Commodity**
- **CAPABILITIES**: Differentiated
- **Few / Empty**
- **CONTRACT VEHICLES**: Many / Winning work
- **<18 months**
- **RECOMPETE TIMING**: >36 months
- **<0%**
- **ORGANIC GROWTH**: >15%
- **At risk / Contractor unfriendly**
- **CUSTOMER MIX**: Well-funded / Contractor friendly
- **Immature**
- **CORPORATE INFRASTRUCTURE**: Mature
- **<$2SM**
- **SCALE**: >$100M

- Highly Differentiated Companies: 12x+
- Companies without Salability Concerns: 8x
# Process Considerations – “Lessons Learned”

## Common Process Errors

<table>
<thead>
<tr>
<th>Error</th>
<th>Relevant Commentary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not having the right team in place...</td>
<td>Important to have your advisors on-board prior to marketing</td>
</tr>
<tr>
<td></td>
<td>Allows each expert appropriate time to prepare for process / address potential transaction risk</td>
</tr>
<tr>
<td></td>
<td>Difficult to bring someone onboard during process / has to play catch up (more expensive and time consuming)</td>
</tr>
<tr>
<td>Lack of preparation before going to market...</td>
<td>Some companies rush to market without adequately preparing (financials, contracts, HR, succession planning, etc.)</td>
</tr>
<tr>
<td></td>
<td>Speed to market often means a longer diligence period and often reduced credibility</td>
</tr>
<tr>
<td>Entertaining one-off discussions...</td>
<td>In this competitive market it is common for quality companies to received “in-bound interest”</td>
</tr>
<tr>
<td></td>
<td>Buyers will often aggressively pursue targets in order to avoid a competitive process - in many cases these discussions end up taking far longer than a standard process</td>
</tr>
<tr>
<td>Aggressive forecast / projections...</td>
<td>A seller negotiating with only one party has limited leverage</td>
</tr>
<tr>
<td></td>
<td>Possibly the biggest reason for a deal to blow up is the seller missing their financial projections</td>
</tr>
<tr>
<td></td>
<td>In a competitive process a projection “miss” will likely lead to a re-price, or the buyer walking away</td>
</tr>
<tr>
<td></td>
<td>Sellers need to project a “brisk walk” picture vs. a “sprint”</td>
</tr>
</tbody>
</table>
WHAT IS SELLER DUE DILIGENCE?

• Diligence is conducted from a buyer’s or interested party’s perspective with the goal of increasing buyer confidence

• Deliverable is a function of the agreed upon scope used as part of the sale process that has been vetted with seller management for factual accuracy and content

• Typically performed as part of an auction, managed sale process, refinancing, etc.

• Is paid for by the seller but intended to reduce overall diligence costs by getting ahead and in front of issues to decrease the chance of unnecessary delays in the sales process.
# Benefits of Seller Diligence

<table>
<thead>
<tr>
<th>Preemptively identify and address areas of concern in advance of sale</th>
<th>Provide realistic expectations regarding normalized EBITDA to prospective buyers</th>
<th>Mitigate likelihood of downward purchase price negotiations</th>
<th>Provide an opportunity to explain circumstances that could be perceived as flaws to prospective buyers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Address carve-out and transitional concerns and Assist with purchase agreement structure</td>
<td>Facilitate a faster, more competitive and less risky sales process contributing to higher value for the seller</td>
<td>Add credibility to data provided to buyer and shorten the buyer’s diligence process</td>
<td>Control the timing, consistency, and nature of the information disclosed</td>
</tr>
</tbody>
</table>
FEASIBILITY OF SELLER DILIGENCE

Seller diligence is most appropriate when...

- There is a short timetable to compete a sales process
- Where the nature of the business being sold is complex, lacks a robust finance or accounting function, is disaggregated with no consolidation, etc.
- Where there are multiple potential purchasers to drive an auction process

Seller diligence is less likely to yield positive results when...

- Seller management does not take the process seriously and/or an ill-considered approach is taken
- Access to the business’s financial records and key entity personnel is severely restricted (e.g., seller’s staff are unaware of the pending sale); QoFE may be warranted
- Where there is limited interest in the business (e.g., one buyer)

Seller diligence minimizes the buyers’ need to conduct their own due diligence which drives...

- Less of a need to give any one bidder exclusivity
- The process can remain highly competitive until the latter phase of the process
- Opportunity for last-minute price negotiation is minimized
- The seller is in control of the timing, consistency, and nature of the information disclosed
QUALITY OF EARNINGS (Q OF E) & WORKING CAPITAL
### Q of E V. AUDIT

**Is it necessary to perform due diligence if the Target’s financial statements are audited?**

<table>
<thead>
<tr>
<th><strong>Q of E</strong></th>
<th><strong>Audit</strong></th>
</tr>
</thead>
</table>
| Scope is wider than an audit and determined by client based on what is relevant for the specific transaction. It includes:  
  • Review of historical results  
  • Quality of earnings analyses  
  • Analyses related to  
    - Sustainability of business  
    - Projections and business plans  
    - Corporate & management structure  
    - Operations and technology  
    - Synergy of target business to buyer’s business  
  • Reliance on management assertions without confirmation to third party documentation  
  • Performed under consulting standards |  
| • Focused only on whether the historical financial statements are fairly stated and in accordance with GAAP  
• Does not cover forecast period  
• Tests transactions and account balances to third party data  
• Procedures defined by professional standards - i.e., GAAS  
• Express an opinion - performed under attest standards, more liability to the professional services firm |
FOCUS AREAS – QUALITY OF EARNINGS

- Attempt to get to a normalized or run-rate EBITDA or earnings stream
- Corrections of errors
- Timing issues
- Non-operating income/expenses
- Noncash transactions
- Nonrecurring transactions
- Normalization adjustments for historical changes in income/expense run-rates
- Pro forma adjustments for expected future transactions - execution risk
FOCUS AREAS – QUALITY OF EARNINGS
COMMON ISSUES TO WATCH FOR

• Management/Proforma addbacks that are subjective not supportable
• No correlation between EBITDA and cash from operations
• "Non-recurring" items of income and expense appears to recur annually (e.g. government grants, gain on sale of assets, etc.)
• Seasonality factors
• Capital expenditure and discretionary spending deferrals
• Allocated charges for shared services not representative of standalone business
QUALITY OF EARNINGS – BUY SIDE

Quality of earnings adjustments

<table>
<thead>
<tr>
<th>$ in thousands</th>
<th>Ref. No.</th>
<th>2015</th>
<th>2016</th>
<th>TTM17</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue, unadjusted</td>
<td></td>
<td>142,634</td>
<td>152,946</td>
<td>154,491</td>
</tr>
<tr>
<td>Revenue adjusted</td>
<td></td>
<td>172,234</td>
<td>173,963</td>
<td>173,055</td>
</tr>
<tr>
<td>Net income</td>
<td></td>
<td>18,057</td>
<td>22,114</td>
<td>23,525</td>
</tr>
</tbody>
</table>

Add-backs

- Depreciation and amortization
  
- Interest expense
  
- Income tax expense

Reported EBITDA

Management adjustments

- Non-recurring expenses
- Non-cash items/non-operating expenses

Total Management adjustments

Diligence adjusted EBITDA

Diligence adjustments

- Reversal of Management adjustments
- Non-cash items/non-operating expenses
- Normalizing adjustments

Total Diligence adjustments

Diligence adjusted EBITDA

Pro forma adjustments

- Additional capacity
- Operating yield improvements
- New product introductions

Total pro forma adjustments

Pro forma EBITDA

% of revenue

Management Adjustments

- Adjustments will typically be taken from either: 1) internal management tracking of non-recurring or non-operating items incurred historically; 2) quality of earnings reports performed by a third party accounting firm; or 3) investment banking CIM document, which is still likely derived from internal management information.

- A buy-side diligence team will work to verify these adjustments and ensure proper supporting documentation is reviewed and verified for reasonableness.

Diligence Adjustments

- Adjustments will typically be around:

  1. **Reversal of management adjustments** - may represent items without proper support or items that are considered recurring in nature.

  2. **Non-cash items/non-operating items** - additional non-operating income or expense items may be noted during diligence procedures. These may include non-core income, stock compensation expense, personal expenses running through the business, etc.

  3. **Normalizing adjustments** - these typically represent a normalization of historical EBITDA run-rate for: a) changes in the business, either operationally or changes in accounting policies that have been implemented; b) true-ups of reserves or accruals that need to be spread out over the respective period; or c) out-of-period adjustments to move income/expense items to the proper period.
QUALITY OF EARNINGS – BUY SIDE

Quality of earnings adjustments

<table>
<thead>
<tr>
<th>$ in thousands</th>
<th>Ref. No.</th>
<th>2015</th>
<th>2016</th>
<th>TTM17</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue, unadjusted</td>
<td></td>
<td>142,634</td>
<td>152,946</td>
<td>154,491</td>
</tr>
<tr>
<td>Revenue adjusted</td>
<td></td>
<td>172,234</td>
<td>173,963</td>
<td>173,055</td>
</tr>
<tr>
<td>Net income</td>
<td></td>
<td>18,057</td>
<td>22,114</td>
<td>23,525</td>
</tr>
<tr>
<td>Add-backs</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td></td>
<td>2,986</td>
<td>4,086</td>
<td>4,106</td>
</tr>
<tr>
<td>Interest expense</td>
<td></td>
<td>357</td>
<td>602</td>
<td>479</td>
</tr>
<tr>
<td>Income tax expense</td>
<td></td>
<td>50</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Reported EBITDA</td>
<td></td>
<td>21,450</td>
<td>26,851</td>
<td>28,159</td>
</tr>
</tbody>
</table>

Management adjustments

- Non-recurring expenses MA-01: 320, 1,200, 1,248
- Non-cash items/non-operating expenses MA-02: 302, 75, 75
- Total Management adjustments: 822, 1,275, 1,322

Diligence adjusted EBITDA: 22,072, 28,126, 29,482

Diligence adjustments

- Reversal of Management adjustments DD-01: (367), (481), (433)
- Non-cash items/non-operating expenses DD-02: 825, 430, 430
- Normalizing adjustments DD-03: 2,257, 1,435, 147
- Total Diligence adjustments: 2,716, 1,384, 144

Diligence adjusted EBITDA: 24,788, 29,510, 29,626

Pro forma adjustments

- Additional capacity PF-01: 6,082, 3,364, 3,152
- Operating yield improvements PF-02: 2,579, 2,783, 2,794
- New product introductions PF-03: 2,841, 3,120, 3,104
- Total pro forma adjustments: 11,302, 9,267, 9,050

Pro forma EBITDA: 36,090, 38,777, 38,676

% of revenue

- Reported EBITDA %: 12.5%, 15.4%, 16.3%
- Management adjusted EBITDA %: 14.4%, 17.0%, 17.1%
- Diligence adjusted EBITDA %: 14.4%, 17.0%, 17.1%
- Pro forma EBITDA %: 21.0%, 22.3%, 22.3%

Pro forma Adjustments

- Pro forma adjustments are adjustments where there is execution risk on the Company’s behalf in order to realize the EBITDA benefit or reduction in EBITDA.
- Some examples may include:
  1. New manufacturing facility opening in the next six months will lead to additional revenue/EBITDA
  2. New product introduction will likely lead to additional revenue/EBITDA
  3. Top 10 customer may be lost in the next six months due to contract running out and customer indicating they may not renew
  4. Operational initiatives that are currently being implemented but have not yet obtained full run-rate of savings (may be split between diligence adjustment and pro forma adjustment).
- The key for pro forma adjustments is that the event that gives rise to a change in EBITDA has not occurred yet. Even if the event has occurred after the last month of the reported period, an adjustment can be made if there is proper supporting information available to estimate a potential impact to EBITDA.
QUALITY OF EARNINGS – SELL SIDE

Quality of earnings adjustments

<table>
<thead>
<tr>
<th>$ in thousands</th>
<th>Ref. No.</th>
<th>2016</th>
<th>2017</th>
<th>TTM18</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue, unadjusted</td>
<td></td>
<td>142,634</td>
<td>152,946</td>
<td>154,491</td>
</tr>
<tr>
<td>Revenue adjusted</td>
<td></td>
<td>172,234</td>
<td>173,963</td>
<td>173,055</td>
</tr>
<tr>
<td>Net income</td>
<td></td>
<td>18,057</td>
<td>22,114</td>
<td>23,525</td>
</tr>
</tbody>
</table>

Add-backs
- Depreciation and amortization: 2,986, 4,086, 4,106
- Interest expense: 357, 602, 479
- Income tax expense: 50, 50

Reported EBITDA: 21,450, 26,851, 28,159

Management adjustments
- Non-recurring expenses: MA-01, 672, 481, 529
- Non-cash items/non-operating expenses: MA-02, 825, 430, 430
- Normalizing adjustments: MA-03, 2,257, 1,435, 147

Total Management adjustments: 3,755, 2,346, 1,106

Management adjusted EBITDA: 25,205, 29,197, 29,266

Pro forma adjustments
- Additional capacity: PF-01, 6,082, 3,364, 3,152
- Operating yield improvements: PF-02, 2,579, 2,783, 2,794
- New product introduction: PF-03, 2,641, 3,120, 3,104

Total pro forma adjustments: 11,302, 9,267, 9,050

Pro forma EBITDA: 36,507, 38,464, 38,316

% of revenue
- Reported EBITDA %: 12.5%, 15.4%, 16.3%
- Management adjusted EBITDA %: 14.6%, 16.8%, 16.9%
- Pro forma EBITDA %: 21.2%, 22.1%, 22.1%

Sell side adjustments
- Sell side diligence adjustments are typically performed in conjunction with the Seller’s Management team.
- The categorization of the adjustments should generally be similar to a buy-side process and may include:
  1. **Non-recurring income/expenses** - professional fees, insurance reimbursements, consulting costs, transaction costs, excess freight, inventory adjustments, etc.
  2. **Non-cash/non-operating items** - stock compensation expense, purchase accounting adjustments, personal(non-business) related expenses, gains on sale of assets, management fees, etc.
  3. **Normalization adjustments** - compensation normalization, normalization of operational changes, accrual/reserve normalization.
  4. **Accounting adjustments** - changes in accounting policies, LIFO reserves, capitalization of expenses (labor, consulting costs, etc.)
  5. **Pro forma adjustments** - similar to prior page
- Quality of earnings table will rarely show management adjustments and then reversal of management adjustments. This gives the appearance of a potential disagreement with Management, which most accounting firms want to avoid.
- Supporting documentation should be noted and will have been reviewed by the sell-side team.
FOCUS – QUALITY OF EARNINGS
COMMON ISSUES TO LOOK OUT FOR

• Proforma addbacks that are subjective not supportable
• No correlation between EBITDA and cash from operations
• "Non-recurring" items of income and expense appears to recur annually (e.g. government grants, loss on sale of fixed assets, etc.)
• Seasonality factors
• Capital expenditure and discretionary spending deferrals
• Allocated charges for shared services not representative of standalone business
**FOCUS – QUALITY OF EARNINGS**

**CARVE-OUT STAND ALONE CONSIDERATIONS**

- The previous slide assumes stand-alone and audited financials, but in many instances we encounter financial reporting that is more limited.

- **Common issues:** (1) no stand-alone financial statements and results must be carved out, (2) balance sheet or income statement accounts that cannot be carved out, (3) no audited or reviewed data, and (4) limited or no controls over key accounts (e.g., no physical inventory counts).

- **Carve-out issues:** (1) shared services (corporate, sister divisions), (2) shared costs (corporate, sister divisions), (3) commingled receivables and payables that are not identifiable on a division basis, (4) allocations aren't prepared historically to be able to show carve out “loaded” cost.

- **Responses to carve-out limitations:** (1) understand what costs and services are burdened on the carved out results and where those amounts are recorded (i.e., above or below gross margin), (2) understand the go-forward value of the services not burdened on the income statement, (3) based on post-transaction structure of acquired division, perform analysis to produce a contribution margin that reflects what the buyer can anticipate post close, and (4) perform detailed testing on significant accounts to verify accuracy and completeness.
FOCUS – QUALITY OF WORKING CAPITAL

• Typically most transactions are structured on a cash (or excess cash) and debt-free basis, with a working capital target at closing.

• It is critical that both buyer and seller evaluate historical working capital trends by month (going to the trial balance level of account) as well as near term forecast levels, and establish a normal/pro-forma and fair level of working capital at closing.

• In fast growing companies, forecasted working capital will be more relevant than historical levels.

• Impact of seasonality is also important.

• Items excluded from working capital may be considered debt-like items (e.g. accrued interest, accrued bonuses, tax liabilities, deferred revenue, outstanding checks, etc.)
FOCUS – QUALITY OF WORKING CAPITAL

• Measure true value of assets being acquired and implications on purchase price adjustment

• Accounts receivable/DSO and inventory/DIOH trends

• Contingent liabilities/off-balance sheet financing and commitments

• Reserves and deferred costs

• Industry-specific accounting issues (e.g. revenue recognition of multiple elements, etc.)

• Enough working capital to run business post acquisition?

• Understand impact of seasonality

• How to treat deferred revenue

• How are outstanding checks treated?
QUALITY OF WORKING CAPITAL

Adjusted working capital

<table>
<thead>
<tr>
<th>$ in thousands</th>
<th>Ref. No.</th>
<th>Dec-16</th>
<th>Dec-17</th>
<th>Aug-18</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and cash equivalents</td>
<td>WC-11</td>
<td>(1,273)</td>
<td>(1)</td>
<td>(3,869)</td>
</tr>
<tr>
<td>Accounts receivable, net</td>
<td>WC-02</td>
<td>2,552</td>
<td>2,678</td>
<td>3,202</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>WC-03</td>
<td>429</td>
<td>742</td>
<td>838</td>
</tr>
<tr>
<td>Inventory</td>
<td>WC-04</td>
<td>8,318</td>
<td>8,100</td>
<td>6,307</td>
</tr>
<tr>
<td>Trade Payables</td>
<td>WC-05</td>
<td>5,316</td>
<td>4,341</td>
<td>2,762</td>
</tr>
<tr>
<td>Other Payables/Accruals</td>
<td>WC-06</td>
<td>147</td>
<td>135</td>
<td>125</td>
</tr>
<tr>
<td>Accrued Wages</td>
<td>WC-07</td>
<td>910</td>
<td>971</td>
<td>1,105</td>
</tr>
<tr>
<td>Taxes Payable</td>
<td>WC-08</td>
<td>429</td>
<td>742</td>
<td>838</td>
</tr>
<tr>
<td>Commissions Payable</td>
<td>WC-09</td>
<td>179</td>
<td>142</td>
<td>114</td>
</tr>
<tr>
<td>Outstanding Checks</td>
<td>WC-10</td>
<td>1,273</td>
<td>1,105</td>
<td>900</td>
</tr>
<tr>
<td>Interest Payable</td>
<td>WC-11</td>
<td>(985)</td>
<td>(1,350)</td>
<td>(1,200)</td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
<td>19,635</td>
<td>19,635</td>
<td>22,335</td>
</tr>
<tr>
<td>Current liabilities</td>
<td></td>
<td>9,413</td>
<td>9,031</td>
<td>6,569</td>
</tr>
<tr>
<td>Working capital</td>
<td></td>
<td>10,423</td>
<td>10,604</td>
<td>15,766</td>
</tr>
<tr>
<td>Adjustments</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Normalization of workers comp accrual</td>
<td>WC-01</td>
<td>-</td>
<td>-</td>
<td>53</td>
</tr>
<tr>
<td>Normalization of ERP upgrade liability</td>
<td>WC-02</td>
<td>16</td>
<td>46</td>
<td>-</td>
</tr>
<tr>
<td>Normalization of equipment removal liability</td>
<td>WC-03</td>
<td>82</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Impact of feed mill overcharge</td>
<td>WC-04</td>
<td>(27)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>CIP included in AP</td>
<td>WC-05</td>
<td>151</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Interest payable</td>
<td>WC-06</td>
<td>59</td>
<td>33</td>
<td>(34)</td>
</tr>
<tr>
<td>Outstanding Checks</td>
<td>WC-07</td>
<td>-</td>
<td>-</td>
<td>985</td>
</tr>
<tr>
<td>Customer A revenue adjustment</td>
<td>WC-08</td>
<td>-</td>
<td>-</td>
<td>(46)</td>
</tr>
<tr>
<td>Normalization of allowance for doubtful accounts</td>
<td>WC-09</td>
<td>-</td>
<td>(3)</td>
<td>(61)</td>
</tr>
<tr>
<td>Normalization of vacation accrual</td>
<td>WC-10</td>
<td>-</td>
<td>-</td>
<td>(120)</td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>WC-11</td>
<td>(1,273)</td>
<td>(1)</td>
<td>(3,869)</td>
</tr>
<tr>
<td>Total WC adjustments</td>
<td></td>
<td>(992)</td>
<td>1,060</td>
<td>(4,076)</td>
</tr>
<tr>
<td>Adjusted working capital</td>
<td></td>
<td>9,464</td>
<td>11,664</td>
<td>11,689</td>
</tr>
</tbody>
</table>

Unadjusted ratios

- **DSO (days)**: 18, 20, 18
- **DIO (days)**: 61, 55, 43
- **DPO (days)**: 16, 13, 8
- **CCC (days)**: 63, 62, 52

- Typical adjustments per a Letter of Intent (e.g., “cash-free; debt-free”):
  - Cash (may be adjusted for excess cash only and may include outstanding checks)
  - Short-term debt and accrued interest
- Other potentially excluded Assets/Liabilities or debt-like items include:
  - Income tax-related balances (accrued/deferred income taxes)
  - Non-cash balances (deferred rent)
  - Balances to be settled prior to closing (related-party balances, certain payroll-related liabilities, employee advances, etc.)
  - Transaction-related balances (typically accrued professional fees)
  - Capital expenditures in accounts payable
- Diligence team should marry all EBITDA adjustments to the related working capital impact, as applicable.
- Important to include well-worded definitions for the components of working capital in the purchases agreement and ideally include an example in the exhibits
GOVERNMENT CONTRACTING FOCUS AREAS

• Generally no different than diligence for any other industry

• May put additional focus on the following areas:
  – Revenue recognition under government contracts (e.g. ship-in-place arrangements, POC accounting, management reserves, etc.)
  – Review of contracts for major terms (e.g. billing requirements, contracts covered under CAS, pricing and payment terms, etc.)
  – Standing with government agencies (e.g. incurred cost submissions, audits, Inspector General investigations, etc.)
  – Review of company’s billing rates (e.g. how rates are calculated and monitored, Forward Pricing Rate arrangements, etc.)
  – Review of contingent and unrecorded contract liabilities (e.g. defective pricing, regulatory investigations, unsettled claims, etc.)
### EXAMPLE TIMELINE FOR QoFE PROCESS

<table>
<thead>
<tr>
<th>TASKS</th>
<th>WEEKS</th>
</tr>
</thead>
<tbody>
<tr>
<td>X=Deliverable</td>
<td></td>
</tr>
<tr>
<td>Kick-off meeting and review compilation of client information listed in CohnReznick’s information request document. CohnReznick will work off-site to evaluate CLIENT’s information.</td>
<td>1</td>
</tr>
<tr>
<td>Completion of on-site field visit meetings.</td>
<td>2</td>
</tr>
<tr>
<td>Completion of diligence analysis and reporting writing.</td>
<td>3</td>
</tr>
<tr>
<td>Follow-up and feedback to management.</td>
<td>4</td>
</tr>
<tr>
<td>Presentation and review of report by management.</td>
<td>5</td>
</tr>
<tr>
<td>Update report based on management revisions/comments. Deliver final report.</td>
<td>6</td>
</tr>
<tr>
<td>Work with investment bankers to confirm that CLIENT’s report is consistent with the CIM.</td>
<td>7</td>
</tr>
<tr>
<td>Distribute CohnReznick report to prospective buyers after completion of access letter.</td>
<td>8</td>
</tr>
<tr>
<td>Communication with prospective Buyers discussing CohnReznick’s report, as required.</td>
<td>9</td>
</tr>
<tr>
<td>Report update, if required.</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>11</td>
</tr>
<tr>
<td></td>
<td>12</td>
</tr>
</tbody>
</table>
### TYPICAL SELLER QUESTIONS AND CONCERNS – “LESSONS LEARNED”

<table>
<thead>
<tr>
<th>Question</th>
<th>Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Are we paying for buyer diligence?</td>
<td>• Seller diligence will increase the quality of bids and should help to maximize value of the sale more than offsetting the costs involved. Additionally, by reducing potential buyer diligence, there is less of a need to provide exclusivity to any one buyer.</td>
</tr>
<tr>
<td>Won’t buyers still perform their own diligence?</td>
<td>• Yes, but by working with the seller to set the scope so that buyer focus should be limited to key areas.</td>
</tr>
<tr>
<td>Will identified issues portray the Company in a negative light?</td>
<td>• Potential buyers are looking for credible information. It is of the utmost importance to provide information that accurately reflects the business. The seller will have the opportunity to comment on and screen the deliverable, providing the opportunity to address issues proactively. This is not possible when potential buyers perform their own diligence.</td>
</tr>
<tr>
<td>Will the process commandeer too much of seller management time?</td>
<td>• In the context of the overall sale process, less time will be required of seller management as the buyers perspective that we bring will pre-empt much of potential buyer inquiry.</td>
</tr>
<tr>
<td>Will seller diligence disclose too much information?</td>
<td>• Seller diligence allows the seller to have greater knowledge and control over the information presented. Potential buyers will likely identify the same or similar issues anyway.</td>
</tr>
</tbody>
</table>
LETTER OF INTENT

• How Did We Get Here?
  – 1st phase of negotiations of Acquisition Transaction completed
  – Buyer & Seller should each have had the benefit of their lawyer’s, accountant’s, & financial advisor’s advice
  – NDA in place & some financial & other info exchanged

• Where Are We Going?
  – A key next step is negotiating and drafting the Definitive Acquisition Agreement

• Have a Roadmap!
  – To get there, we’ll need a roadmap - An outline of substantive deal terms to the non-binding expressions of their then current understanding of the deal & certain binding provisions
WHY A LETTER OF INTENT?

• “Got to be Real” https://youtu.be/tlCC1XojRzM?t=36
  – Testing the waters before incurring the costs and expending lots of time negotiating definitive agreements & due diligence

• Mutual Understanding of Deal Terms?
  – Are we on the same page? Find out deal-breakers now

• Without Signed Writing is there an Obligation for Anything?
  – Probably not - “moral obligation”

• Evaluation By Investors and Lenders
  – Helps buyer in convincing prospective lenders or investors to evaluate transaction for the purpose of providing financing
WHO DRAFTS THE LETTER?

• Buyer’s Team
  – Legal, Accounting, & Financial Advisors draft letter with Buyer

• Seller’s Team
  – Legal, Accounting, & Financial Advisors draft response with Seller

• Financial and Tax Modeling
  – Each party should have done its own valuation
  – What $ will sellers actually receive? When?
  – Planning opportunities
PART ONE-NONBINDING PROVISIONS

The parties wish to commence negotiating a definitive written acquisition agreement providing for a possible acquisition. The execution of any Definitive Agreement would be subject to the satisfactory completion of Buyer’s ongoing investigation of the Seller’s business and would also be subject to approval by Buyer’s board of directors.

Based upon the information currently known to Buyer, it is proposed that the Definitive Agreement would include the following terms:

1. BASIC TRANSACTION

Sellers would sell all the Shares/Assets to Buyer at the price (the “Purchase Price”) set forth in Paragraph 2 at the closing of the possible Transaction, which is expected to be no later than ______________.
INTENT OF THE PARTIES: BINDING AND NON-BINDING

PART ONE - NONBINDING PROVISIONS

2. PURCHASE PRICE

The Purchase Price would be $_____________ (subject to adjustment as described below) and would be paid in the following manner:

- Cash at closing
- Promissory Note
- Earn-outs
- Escrow vs Holdback
- Purchase Price Adjustments--Working Capital or Stockholders’ Equity
INTENT OF THE PARTIES: BINDING AND NON-BINDING

PART ONE - NONBINDING PROVISIONS

3. EMPLOYMENT AND NONCOMPETITION AGREEMENTS
   • Controlling owners
   • Key employees
   • Compensation and Transition
   • Non-competes can be for longer term than employment non-competes
INTENT OF THE PARTIES: BINDING AND NON-BINDING

PART ONE - NONBINDING PROVISIONS

4. REPRESENTATIONS, WARRANTIES & INDEMNIFICATION

Sellers would make comprehensive representations and warranties to Buyer and would provide comprehensive covenants, indemnities, and other protections for the benefit of Buyer. The consummation of the possible acquisition by Buyer would be subject to the satisfaction of various conditions required to be satisfied prior to Closing.

- Ownership, authority, enforceability
- Material Contracts, IP rights, Taxes, Financial Statements
- No Material Adverse Change
- Employment, Environmental, Cyber, Litigation, Compliance
- Such other conditions as are customary in transactions of this type
- “Customary” Indemnification - Details often deferred to Definitive Agreement
PART TWO-BINDING PROVISIONS

The parties, intending to be legally bound, agree to the following legally enforceable paragraphs of this letter.

5. ACCESS

Sellers will cause the Company to afford Buyer and its duly authorized representatives full and free access to the Company, its personnel, properties, contracts, books and records, and all other documents and data, subject to the Confidentiality Agreement.

6. EXCLUSIVE DEALING

- Very important for Buyer
- No Shop clause
  - Don’t want Seller soliciting or entertaining other offers
INTENT OF THE PARTIES: BINDING AND NON-BINDING

PART TWO-BINDING PROVISIONS

7. CONDUCT OF BUSINESS

Sellers shall cause the Company to operate in the ordinary course and to refrain from any transactions outside the ordinary course of business.

• No shifting of assets
• Goal is to preserve value being paid for

8. CONFIDENTIALITY

• More important to Seller
  – Especially if deal does not close - View Buyer as competitor for your customers & key employees
• Pre-existing NDA? No poaching of employees provision

9. COSTS

• Each party responsible for its own costs and expenses including broker’s or finder’s fees
PART TWO-BINDING PROVISIONS

10. TERMINATION

The Binding Provisions will automatically terminate upon the earliest of the following (the “Termination Date”): (i) __________,(ii) execution of the Definitive Agreement by all parties, (iii) the mutual written agreement of Buyer and Sellers, or (iv) written notice of termination by Buyer, for any reason or no reason, with or without cause, at any time; provided, however, that the termination of the Binding Provisions will not affect the liability of a party for breach of any of the Binding Provisions prior to the termination. Upon termination of the Binding Provisions, the parties will have no further obligations under this letter, except Paragraph miscellaneous will survive such termination.

11. EFFECT OF LETTER

• Binding & Non-Binding
INTENT OF THE PARTIES: BINDING AND NON-BINDING

PART TWO-BINDING PROVISIONS

12. MISCELLANEOUS
   • Typical
   • Entire Agreement
   • Modification
   • Governing Law

13. “TIME BOMB”
   • If not signed by seller by ____ - expires by its terms
   • “Got to be Real”
WHO NEEDS TO KNOW?

• Lenders
  – Loan Docs may require notice & approval of change in control or payoff of debts

• Investors
  – What rights do Seller’s shareholders have?

• Others
  – SBA
  – Major customers (Contracting Officers)
  – Key employees
WHO NEEDS TO KNOW? (CONT.)

SBA Business Development 8(A) Program Participants and Small Business Size Standards

13 CFR § 124.105  What does it mean to be unconditionally owned by one or more disadvantaged individuals?

(i) Change of ownership. A Participant may change its ownership or business structure so long as one or more disadvantaged individuals own and control it after the change and SBA approves the transaction in writing prior to the change. The decision to approve or deny a Participant's request for a change in ownership or business structure will be made and communicated to the firm by the AA/BD. The decision of the AA/BD is the final decision of the Agency. The AA/BD will issue a decision within 60 days from receipt of a request containing all necessary documentation, or as soon thereafter as possible. If 60 days lapse without a decision from SBA, the Participant cannot presume that it can complete the change without written approval from SBA. A decision to deny a request for change of ownership or business structure may be grounds for program termination where the change is made nevertheless.

13 CFR 121.103  How does SBA determine affiliation?

(d) Affiliation arising under stock options, convertible securities, and agreements to merge.

(1) In determining size, SBA considers stock options, convertible securities, and agreements to merge (including agreements in principle) to have a present effect on the power to control a concern. SBA treats such options, convertible securities, and agreements as though the rights granted have been exercised.

(2) Agreements to open or continue negotiations towards the possibility of a merger or a sale of stock at some later date are not considered “agreements in principle” and are thus not given present effect.
WHEN DO THEY NEED TO KNOW?
SBA Small Business & Veteran Owned Recertification Obligations

13 CFR § 121.404 When is the size status of a business concern determined?

(g) (1) Within 30 days of an approved contract novation, a contractor must recertify its small business size status to the procuring agency, or inform the procuring agency that it is other than small. If the contractor is other than small, the agency can no longer count the options or orders issued pursuant to the contract, from that point forward, towards its small business goals.

(2) (i) In the case of a merger, sale, or acquisition, where contract novation is not required, the contractor must, within 30 days of the transaction becoming final, recertify its small business size status to the procuring agency, or inform the procuring agency that it is other than small. If the contractor is other than small, the agency can no longer count the options or orders issued pursuant to the contract, from that point forward, towards its small business goals. The agency and the contractor must immediately revise all applicable Federal contract databases to reflect the new size status.

38 CFR 74.15 What length of time may a business participate in the VIP Verification Program?

(a) A participant receives an eligibility term of 3 years from the date of CVE's approval letter establishing verified status.

(b) The participant must maintain its eligibility during its tenure and must inform CVE of any changes that would affect its eligibility within 30 days.

(d) CVE may initiate a verification examination whenever it receives credible information concerning a participant's eligibility as a VOSB. Upon its completion of the examination, CVE will issue a written decision regarding the continued eligibility status of the questioned participant.
SELLER DUE DILIGENCE STARTS MONTHS BEFORE COMPANY GOES TO MARKET – “LESSONS LEARNED”

• Corporate Records Current and Up To Date
• Financial Records Current, Complete and Accurate
• Material Contracts (including employment and non-competes) Must Be Complete, Compliant, Accessible and Assignable
• HR Files and Payroll/Benefits-Always Something
• IP Assets Properly Protected
• Who Needs to Approve Sale? Will They?
• “Real” Compliance Policies
• Cybersecurity Protections and Incidents
SUMMARY & KEY TAKEAWAYS
HOW TO ASSEMBLE YOUR TEAM

Work closely with attorneys, CPA, and investment banking advisors to bring a buyer’s perspective to the seller.

Operate in tandem with buyer advisors so that sell-side analyses complement and support the investment banker’s confidential information memorandum ("CIM").

Provide sell-side services that are scalable based on seller needs. Involvement can range from providing limited work on the front end, to the preparation of a comprehensive report that can be provided to prospective buyers and/or potential financing partners, to closing and post-closing support.
LEAVE NO STONE UNTURNED

**Sourcing and Strategy**

- **HUMAN RESOURCE**
  - Assessment of employees
  - Assessment of medical plans
  - Assessment of retirement and deferred compensation plans
  - Review of workers compensation experience rates and claim history
  - Review of employment agreements

- **OPERATIONS**
  - Site visit and review of facilities
  - Assessment of existing employees and contracts
  - Assessment of relevant intellectual property
  - Review of real estate and related contracts
  - Assessment of synergies and redundancies

- **FINANCE PROCESS**
  - Assessment of current finance systems and integration with overall IT infrastructure
  - Review of financial close process and timing
  - Assessment of:
    - Finance organization
    - Assessment of internal audit function
    - Synergies and redundancies

- **FINANCIAL**
  - Overview of Business Environment and Operations
  - Historical Financial Results
  - Working Capital
  - Financial Projections

- **RISK MANAGEMENT**
  - Assessment of insurance policies including, but not limited, to:
    - General liability
    - Product liability
    - Property & equipment
    - Umbrella
    - Vehicle
    - Cybersecurity
    - Other

- **INFORMATION TECHNOLOGY ("IT")**
  - Assessment of current systems and processes and IT organization
  - Data and network security
  - Assessment of software code
  - Review of software development lifecycle
  - Assessment of third-party service and software providers
  - Cybersecurity risk assessment and testing

---

**Due Diligence**

**Execution**

**Closing**

**Integration**
KEY TAKEAWAYS
Overall “Lessons Learned” for the Owner Considering a Sale

**STEPS TO PREPARE**
→ Put your team in place early
→ Make sure you understand how the market will value your business
→ Think through your transition and key members of your team
→ Do your clean up prior to going to market
→ If you are going to sell, do it once and do it the right way

**KEY AREAS**
→ Legal: open legal issues
→ Legal: contract review and transition
→ Accounting: Q of E / “light” Q of E / audit
→ Accounting: systems, procedures, employees
→ Banking: valuation expectations
→ Banking: Tailored process to meet your objectives
Christine Williamson, CPA, PMP
Partner
Government Contracting Industry Practice
Tysons, VA
☎ 703-847-4412
✉ Christine.Williamson@cohnreznick.com

Jeffrey Michelson, CPA
Managing Director
CohnReznick Advisory
Roseland, NJ
☎ 862-245-5092
✉ Jeff.Michelson@cohnreznick.com

David Kuhnsman
Member
Protorae Law PLLC
☎ 703-639-0679
✉ dkuhnsman@protoraelaw.com

Greg Woodford
Senior Managing Director
The McLean Group
☎ 703-752-9021
✉ gwoodford@mcleanllc.com
PLEASE READ

This presentation has been prepared for information purposes and general guidance only and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice.

No representation or warranty (express or implied) is made as to the accuracy or completeness of the information contained in this publication, and CohnReznick LLP, its members, employees and agents accept no liability, and disclaim all responsibility, for the consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

This presentation and its content are the property of CohnReznick LLP and are protected by applicable copyright laws. Any unauthorized use of the information herein will be considered a violation of CohnReznick LLP’s intellectual property rights. Unless stated otherwise herein, no part of this presentation may be copied, distributed, or published, in whole or in part, without the prior written agreement of CohnReznick LLP.