Farrell Advisory provides professional and highly customized CFO & corporate advisory services.

Preparing A Company For Sale and How The Buy-Side Due Diligence Impacts the Sale Process

June 19, 2015

I. Introduction – Farrell Advisory's Vision

Farrell Advisory enhances clients' market value and comparative advantage by improving decision making, the execution of corporate transactions and its capital and operating structure.

Presentation Structure

II. State of the Market

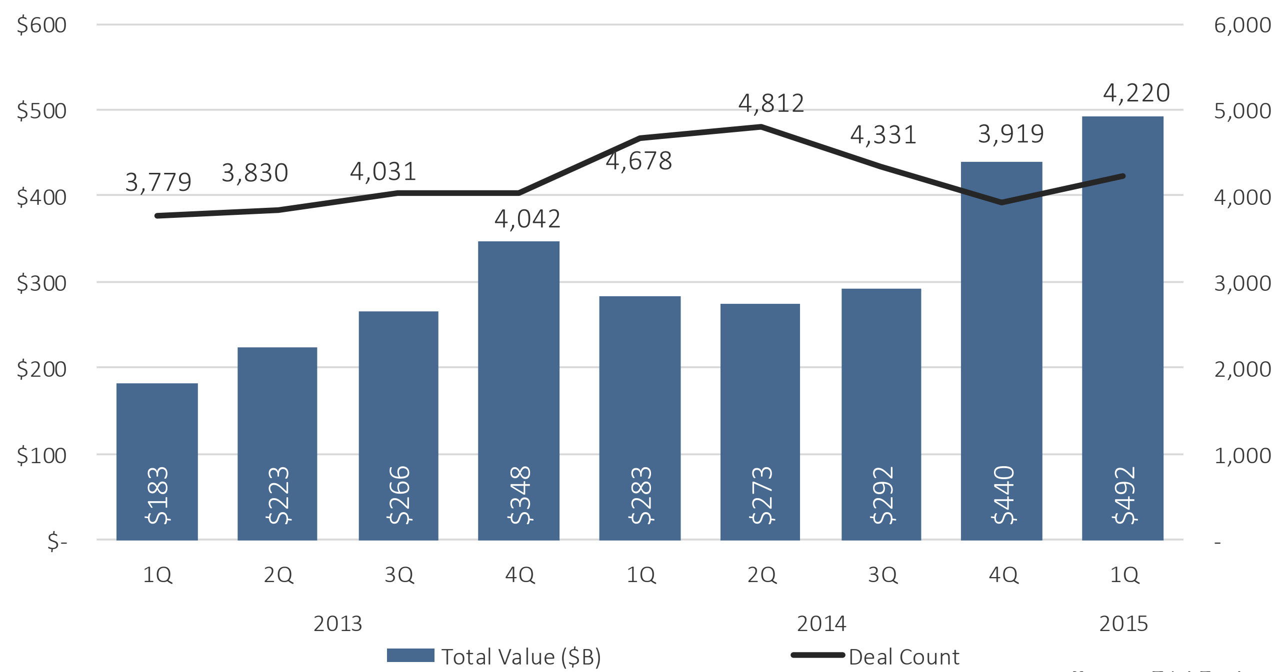
Farrell Advisory enhances clients' market value and comparative advantage by improving decision making, the execution of corporate transactions and its capital and operating structure.

State of the Market

Healthy U.S. M&A Market for Good Businesses

M&A Deal Flow by Quarter

	2013				2014				2015
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q
Sponsor-Backed	$55	$71	$87	$124	$63	$86	$68	$67	$75
Corporate M&A	$128	$153	$179	$224	$220	$188	$224	$374	$418
Total Value ($B)	$183	$223	$266	$348	$283	$273	$292	$440	$492
Sponsor-Backed	847	906	995	1,022	1,130	1,122	1,121	1,050	983
Corporate M&A	2,932	2,924	3,036	3,020	3,548	3,690	3,210	2,869	3,237
Deal Count	3,779	3,830	4,031	4,042	4,678	4,812	4,331	3,919	4,220
Sponsor-Backed	$65	$78	$88	$122	$56	$77	$60	$64	$76
Corporate M&A	$44	$52	$59	$74	$62	$51	$70	$130	$129
Average Value ($ M)	$48	$58	$66	$86	$61	$57	$67	$112	$117



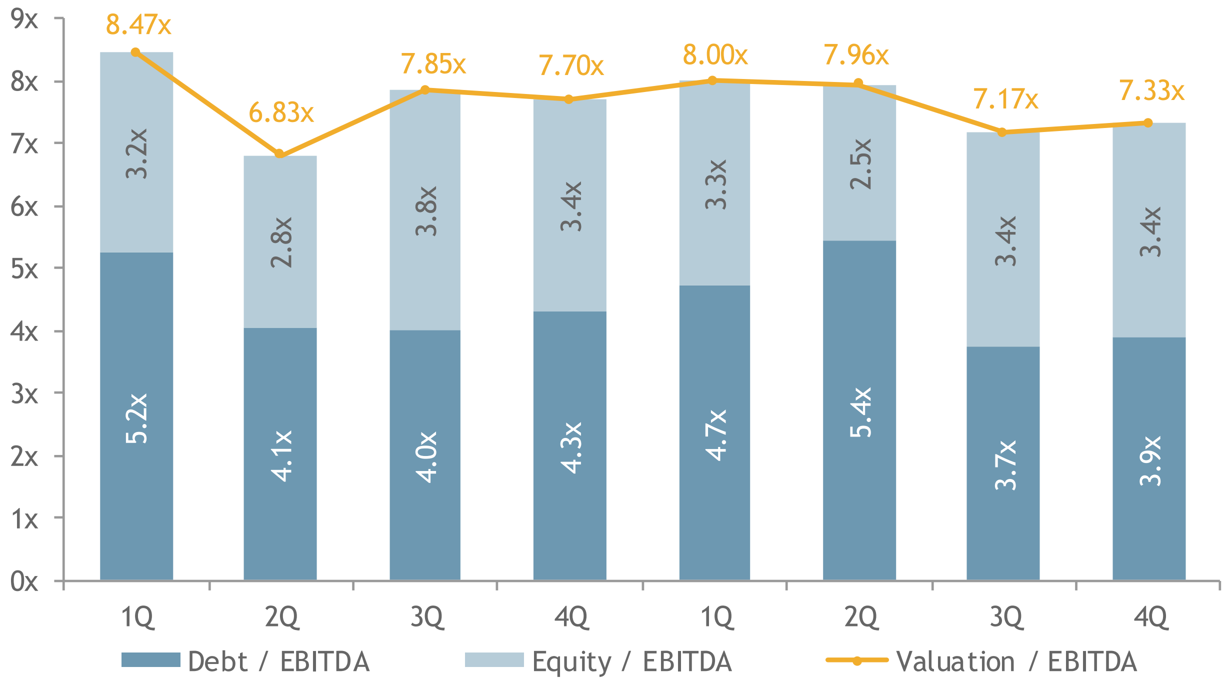
Source: PitchBook

State of the Market

Valuation Multiples – Good Multiples for Good Companies Especially In Open Competitive Auctions

Valuation to EBITDA Multiples

	2013				2014			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Debt / EBITDA	5.2x	4.1x	4.0x	4.3x	4.7x	5.4x	3.7x	3.9x
Equity / EBITDA	3.2x	2.8x	3.8x	3.4x	3.3x	2.5x	3.4x	3.4x
Valuation / EBITDA	8.5x	6.8x	7.9x	7.7x	8.0x	8.0x	7.2x	7.3x



Source: PitchBook

Valuations Can Vary Widely.
Speed and Certainty of Closing a Deal may also be Very Important.

State of the Market

Importance of Understanding (EBITDA) Value Drivers: Government Contracting Value Drivers

Government contracting value drivers are influenced by industry-specific qualitative factors. Valuation multiples can vary greatly depending the Company's attributes.

- 8(a) and set-aside contracts
- Significant % of subcontracts
- Short-term contracts, weak backlog
- Less attractive service offering (pure staffing, facilities management, etc.)
- Commodity-type services

- > 50% prime contracts
- Longer-term contracts
- Stronger backlog
- Some cleared employees
- High % of OCONUS contracts

- Large prime awards
- Long-term, unrestricted contracts
- Strong backlog and visibility
- Highly-Attractive service offerings
- Cleared work

2x – 3x | 3x – 5x | 5x – 6x | 6x – 8x | 8x – 10x | 10x + | Range of EBITDA Multiples

- Less attractive service offering (IT staffing, facilities management, etc.)
- Subcontractor
- Commodity-type services

- High % of prime contracts
- Long-term, unrestricted contracts
- Strong backlog
- Secret & top secret clearances required
- Customer within DoD, DHS, etc.

- Mission critical capabilities and entrenched IP
- Unrestricted prime contracts
- Highly cleared work
- Intelligence/Health IT/Cyber

Source: Business Valuation Resources

III. Options for Selling

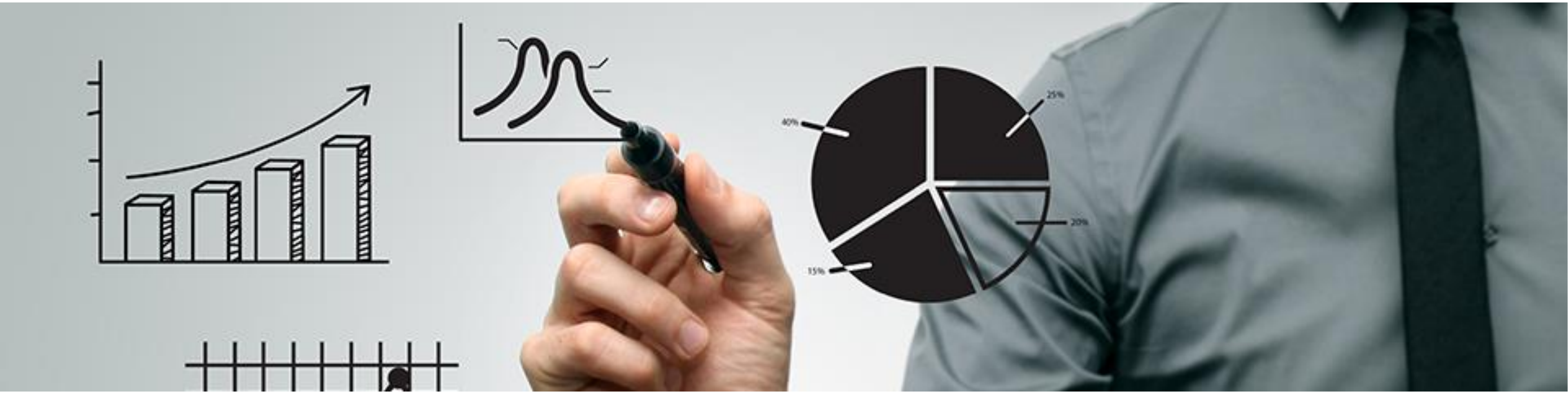
Options for Selling

Overview of Options

CAUTION ↕ AMBITION	OBJECTIVES	TYPE OF EXIT
	Cash out/retirement	Trade Sale/MBO/financial purchaser
	Part cash out/retention of equity/Earn Out	Partial sale to private equity house Sale to strategic buyer with long earn out
	No Potential Cash out	Employee Stock Ownership Plan ("ESOP")
	Capital Growth	Flotation or injection of growth capital

As far as possible, the exit strategy chosen must fit with the needs of all interested parties, including members of the management team who are not shareholders of the business.

IV. Preparing a Company for Sale



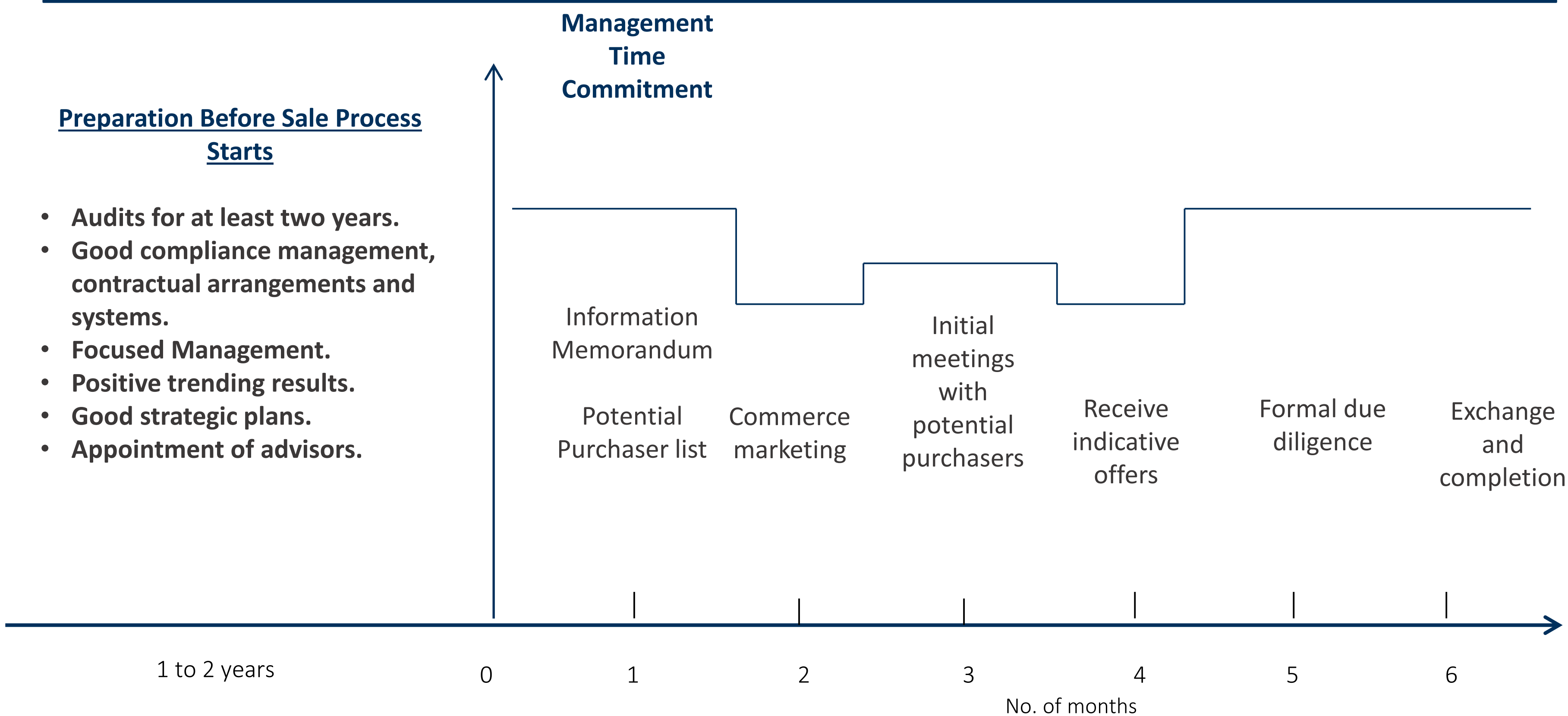
Preparing a Company for Sale

Timetable – It always lakes longer than you think!

Buyers are tending to do more due diligence with more focus on market intelligence and customer references.

Preparation Before Sale Process Starts

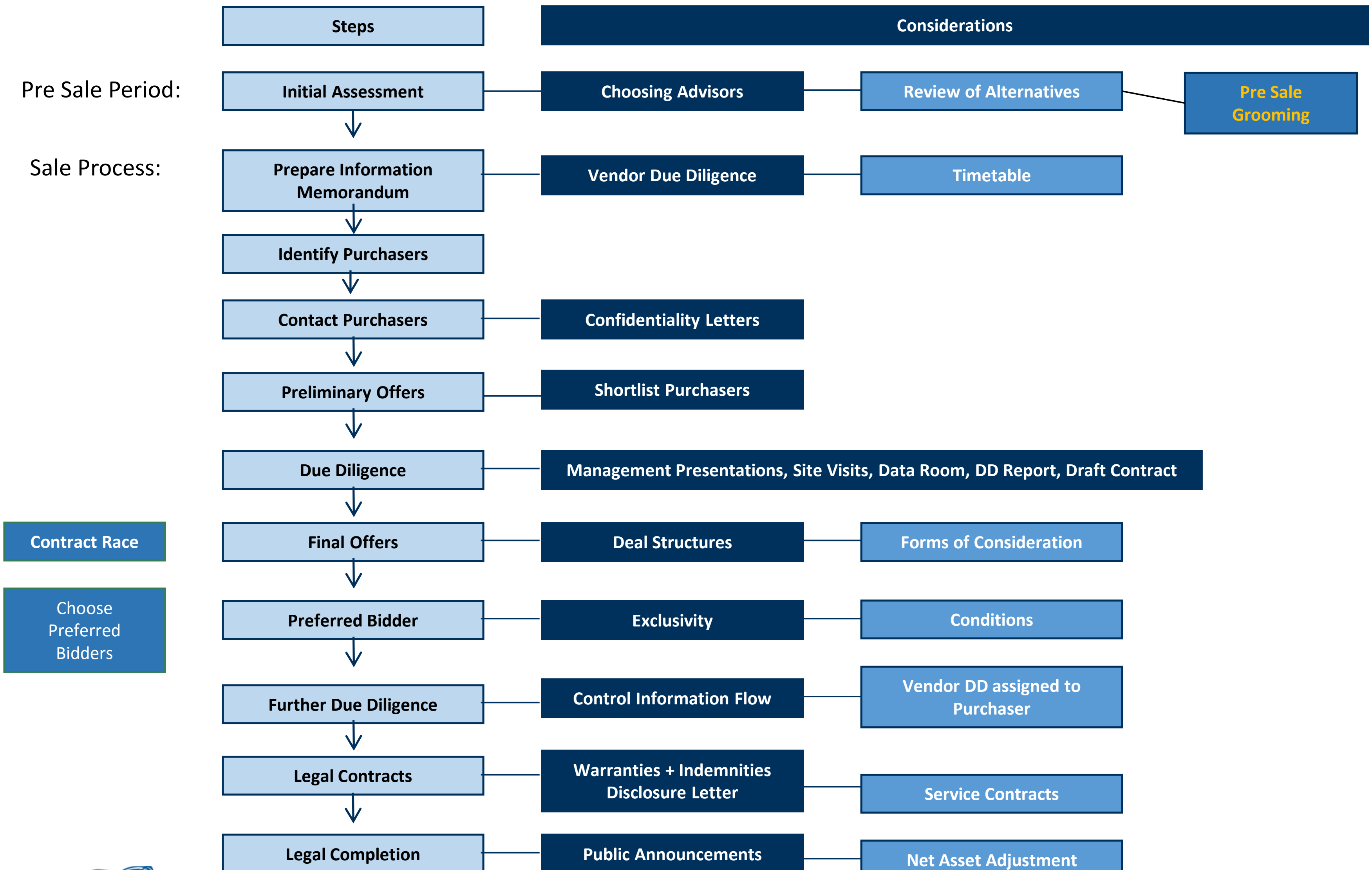
- **Audits for at least two years.**
- **Good compliance management, contractual arrangements and systems.**
- **Focused Management.**
- **Positive trending results.**
- **Good strategic plans.**
- **Appointment of advisors.**



For the Buyer, Due Diligence Starts When You Strategize About Acquisitions, Well Before You Open Discussions with Management.

Preparing a Company for Sale

Sale Process – Formal Auctions



Preparing a Company for Sale

Making the Decision to Sell (1 of 4)

- **What are the seller's objectives?**
  - Am I ready to sell my business?
  - Is the business sellable at the right price?
  - Retirement / Succession problems?
  - Wealth diversification?
  - Release of personal guarantees?
- **Do I have a saleable business?**
- **Has business reached a premium value?**
  - When is the best time to sell my business?
  - When should I start the process?
- **Is capital required to grow the business?**
- **Need to access new markets by being part of a larger (international) business?**
- **Has business reached a size where the owner feels unable or unwilling to manage?**

Preparing a Company for Sale

Making the Decision to Sell (2 of 4)

- Disagreements among shareholders means business is no longer manageable under existing ownership?
- Liquidity issues?
- Business no longer fits within group's core activities or future strategy?
- Competition?
- Ability to use funds elsewhere?

Preparing a Company for Sale

Making the Decision to Sell (3 of 4)

- **What differentiates my business?**
- **Why would someone else be interested in my business?**
  - Technical solutions (e.g., intelligence, cyber security)
  - Markets (e.g., healthcare and IT)
- **Valuation prospect?**
  - Develop REALISTIC expectations of value
  - Understand general transaction structures and related tax implications
    - Stock vs. Asset sale
    - Will my net proceeds achieve my after tax target?
  - No set process – each transaction is different
- **What resources (internal or external) do I need so that I can continue to run my business during the sales process?**
  - Dedicated internal resources
  - Legal and financial advisors
- **Who to tell at work?**
- **Formal or informal auction process**

Preparing a Company for Sale

Making the Decision to Sell (4 of 4)

Importance of Experienced Team

- **Project Management**
- **Attorney**
- **Financial and Accounting Advisor**
- **Business Broker/ Investment Banker**
- **Financial Planner**
- **Integration**

CHEMISTRY, QUALIFICATIONS and EXPERIENCE MATTER!

Preparing a Company for Sale

The sale process (1 of 3)

- **Initial Assessment of Strategic Options by Management and Shareholders**
- **Appointment of Internal and External Advisors**
- **Pre Sale Grooming**
- **Market Company**
  - Teaser
  - CIM
  - Contact potential buyers
  - Information Memorandum
  - Selective data distribution and on site due diligence work
- **Review and Negotiate Offers**
  - Preferred bidder and Exclusivity

Uncertainty and non-incentivized employees can make the process difficult to manage.

Preparing a Company for Sale

The sale process (2 of 3)

➢ Due Diligence (which needs to be carefully project managed)

- Further on site visits and data requests
- Third party advisors
- Acquirer's management team
- Third party visits/contacts (i.e., customers, operations, suppliers)
- Funding/banking due diligence
- Discussions with Management
- Proposals for Company by Buyer
- Financial
  - At least two years of annual audited financial statements
  - Monthly forecast statements with analysis
  - Forecasts for at least 18 months
  - Normalized quality of earnings analysis
- Legal
  - Structure of business being sold
  - Collation of documents
  - Tax review
  - Complete executed contracts (e.g., vendors, employees and customers)

Preparing a Company for Sale

The sale process (3 of 3)

- **Due Diligence (which needs to be carefully project managed), continued**
  - Commercial and Operational
    - Earnings growth
    - Customer and product /service analysis
    - Commitment of management
  - HR
  - Environmental
  - Culture
  - Functional/Compliance-Specific (e.g., government contracting, healthcare)
  - IT
  - Operations/Vendors/Management
  - Customers
- **Negotiation of Legal Contracts**
- **Legal Completion and Announcements**
- **100 Day Post Completion Plan**

Make use of Electronic Data Rooms. Buyers like data in Excel/Word/PowerPoint; not in pdf format. Be transparent and supply data in a timely manner at the appropriate time.

Preparing a Company for Sale

Compliance Issues

- **Government Contracting**
  - Federal procurement rules/ federal acquisition regulation
  - Submission of standard costs
  - Cost Accounting Standards Administration
    - Cost recovery and profit maximization via use of different cost centers
    - Status of DCAA audits
  - Foreign Corruption Practices Act (“FCPA”)
  - Truth in Negotiations Act / Dispute risk avoidance
- **Tax**
- **Environmental**
- **Labor laws**
- **Health & Safety**
- **Licensing**
- **Data protection**

Preparing a Company for Sale

Increase the Attractiveness of your Business? (1 of 4)

- **Understand who the Buyers are and what are their goals and objectives**
- **Generally, two main categories with different goals and objectives:**
  - Financial
    - Private Equity – platform/add-on
    - Venture Capital
    - Hedge Funds
    - Investment Funds
  - Strategic

Preparing a Company for Sale

Increase the Attractiveness of your Business? (2 of 4)

➢ Financial vs. Strategic

Buyer Profiles	Financial	Strategic
Invest in management	X	
Seeking synergistic value		X
Acquire "ideas"	X	X
Acquire IP		X
Drive value through process improvements	X	
Enter new markets		X
Gain new technology		X
Management stays	X	No - Maybe?
Future Sale	X	Maybe?

Preparing a Company for Sale

Increase the Attractiveness of your Business? (3 of 4)

- **Profitability**
  - Demonstrate recurring (increasing) profitable results for at least 3 years
  - Demonstrate improving EBITDA measures
  - Quality of financial results (e.g., audit and good internal controls)
  - Provide a clear picture of owner compensation (including benefits)
  - Take actions or identify areas to improve profitability
  - Address unprofitable locations, products or services
  - Assess synergies and opportunities for acquirer
- **Resolve outstanding legal issues**
- **Resolve outstanding customer/vendor issues**
- **Evaluate / resolve tax issues and tax structuring**
- **Proper management structure for post completion**
- **Good data room and prepared management presentations**
- **Disclose all relevant information – even NEGATIVE issues**
- **Update expired or outdated contracts**

Preparing a Company for Sale

Expanding Buyer Discussions (4 of 4)

- Preferable to inform only a small number of employees
- On site due diligence
- Customer due diligence
- News of disposal could negatively impact business

A "Hymn Sheet" should be prepared in advance containing a response to a leak agreed by both vendors and their advisors.

Preparing a Company for Sale

Exclusivity

- **A purchaser will almost invariably insist on a period of exclusivity**
  - Cost of engaging advisors
  - Assurance that buyer will not be primed for competitor bidder
- **Before exclusivity is provided, check**
  - Terms with other buyers
  - Cash, stock, future performance, timing
  - Financing of buyer
  - Certainty of transactions
  - What is the offer subject to?
  - Due diligence
- **Length of exclusivity is always a matter of negotiation**
  - Typically six to eight weeks
  - May be longer if buyer needs to raise money or seek shareholders approval
  - Withdraw if price is lowered

Preparing a Company for Sale

Factors Contributing to Delay

- **Badly project managed process by Buyer and to some extent Seller**
  - Timely and structured information flow
  - Limited access to management
  - Pre-populated and well structured data room including market data
  - Financial results not in accordance with GAAP and/or not audited
  - Surprises (e.g., forecasts not being supported by historical trends, budgets not being met)
  - Uneducated buyer
  - Number of buyers
- **Size of company**
- **Geographical spread of business**
- **Amount of due diligence required by Buyer (e.g., market data) and financing partners**
- **Access to customer reference sites (contracting officer) and informal customer**
- **approval for acquisition**
- **Potential requirement for shareholder approval**
- **Regulatory approval**

V. Deal Structuring

Deal Structuring

Valuations (1 of 2)

General

- Typically based on normalized EBITDA or free cash flow (EBITDA as adjusted for working capital and capital expenditure)
  - Historical and forecast earnings

- Multiples depend on
  - Strength/specialty of business
  - Strength of management
  - Contract performance
  - Focus of government/market conditions
  - Technical abilities
  - Depth of customer relationships/backlog
  - Potential earnings growth
  - Comparable companies
  - Synergies with buyer
  - Competition
  - Recurring nature of earnings
  - Auctions
  - Speed of closing
  - Type of buyer

Good preparation can increase the speed of the disposal price and the valuation.

Deal Structuring

Key Approval Process

➢ Strategic

- Core management
- Board
- Banks
- Shareholder approval

➢ PE

- Core Management (and may be from portfolio company)
- Financing
- Credit committee

Deal Structuring

Minimizing Tax Implications

- **"S" versus "C" corporations**
- **Asset versus stock sale**
- **Dividends**
- **Deferred consideration**
  - Earn outs can reduce the ability for buyers to restructure business and/or make decisions for the long-term

- **Potential risk that tax rates could change.**

Importance of revolving tax implications at an early stage.

Deal Structuring

Deal Structure Impacts Due Diligence

- **Deferred consideration**
  - Capital gain treatment for sellers
  - No step up in basis for buyer – loss of tax shield
  - Buyer has greater risk of exposure to contingent liabilities
- **Asset**
  - Ordinary income for seller (but may be able to offset against losses)
  - Difficult to transfer key contracts (assignment/novation)
  - Buyer gets step up
  - Buyer gets benefit of tax shield
- **Section 338(h)(10) – best of both?**
- **Earn-outs**
- **Cash versus Stock versus Escrow Account**
- **Seller financing**

Objective is to maximize net proceeds (e.g., after tax and costs) while minimizing risks and period of collection.

VI. Assessing Value Through Due Diligence

Assessing Value Through Due Diligence

What is Due Diligence?

- **The identification of risk through analysis of a company's historical performance.**
- **Generally, part of an acquisition or divestiture process.**
- **Due diligence is as much an art as it is a science.**
- **Used by investors and lenders as a means to reduce investment risks through a focus on:**
  - Financial matters
  - Tax compliance and structure
  - Legal, compliance and regulatory issues
  - Operational
  - Strategic / synergistic opportunities

Assessing Value Through Due Diligence

Why Undertake Due Diligence?

"According to a McKinsey Consulting study, of 115 large acquisitions in the early 1990s, 60 percent were considered failures within five years."

- Mergers, Acquisitions, and Organizational Effectiveness

- **Enhance opportunities to improve shareholder value**
- **Required by lenders or board of directors**
- **Verify key assumptions**
- **Use to bridge buyer & seller expectation gaps**
- **Used to validate assumptions**
- **Needed to identify and quantify synergistic opportunities**
- **Is purchase price supportable**
- **What is the buyer really getting (key customers, management, Intellectual Property)**
- **Country specific risks in cross border transactions**

Are you Maximizing Shareholder Value?

Assessing Value Through Due Diligence

The Economy's Impact on Due Diligence

- **Buyers must make better investment decisions**
  - Greater emphasis on Quality of the Forecast
  - What stage are we in the Economic Cycle?
- **Working capital needs**
- **New business combination accounting guidelines**
  - (Fair Value Standards)
- **Larger gaps in Seller valuation expectations**
- **Financing structure**
  - Seller financing to close the gap and bridge senior debt shortfalls
  - Higher use of earn outs and alternative structures
- **Lender requirements**
  - Loan covenants
- **Availability of credit**

Assessing Value Through Due Diligence

Typical Diligence Requests

- 2 years audited results
- Monthly results plus (financial and operational) statistics for at least 2 years plus trailing twelve months results
- At least 18 months of forecasts
- Unusual or non-recurring terms in financial statements
- Capex and/or working capital requirements
- Customer and product / services analysis
- Intellectual property rights
- Copies of key contracts
- Employee details
- Summary of property
- Summary of trading and legal disputes

Make use of pre-populated electronic data rooms.
Advisors love data in Excel, Word, and PowerPoint, not pdf format.

Assessing Value Through Due Diligence

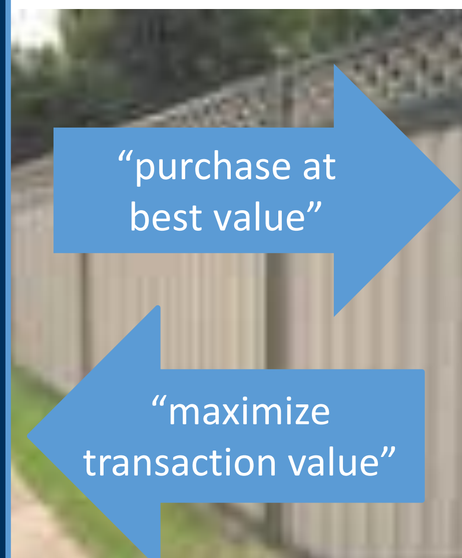
Due Diligence – The Easy Way

Goddard Cartoon ©PharmaVentures; all rights reserved

Assessing Value Through Due Diligence

What Side of the Transaction Are You On?

Buy Side



"purchase at best value"

"maximize transaction value"

Sell Side

Assessing Value Through Due Diligence

Financial Due Diligence - Overview

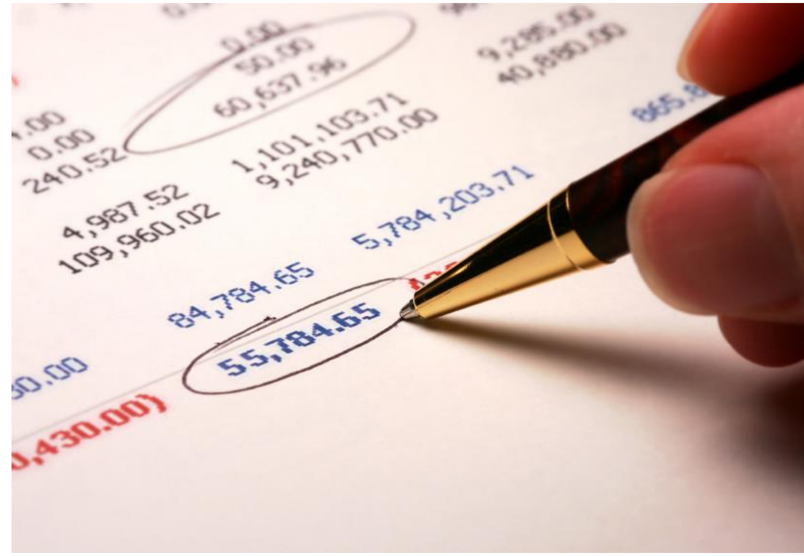
➢ The financial due diligence process includes an assessment of:

- US GAAP compliance/departures
- Overall financial trends
- Regulatory reporting risks
- Sustainability of positive trends or the ability to reverse adverse trends
- Quality of earnings
- Quality of assets
- Working capital

Assessing Value Through Due Diligence

Financial Due Diligence - Quality of Earnings

- **EBITDA – Earnings before Interest, Taxes, Depreciation & Amortization**
- **A measure of the cash earnings power of a business**
- **EBITDA multiples typically drive the transaction value and leverage aspect of a deal**
- **Sellers have a natural tendency to overstate Adjusted EBITDA in an effort to inflate the enterprise value of a business**



Assessing Value Through Due Diligence

Financial Due Diligence – Recurring Income

- **Differs from a financial statement audit which is traditionally focused on the balance sheet**
- **Financial due diligence is focused on the RECURRING income statement**
  - Revenues and expenses are reflected in the proper periods
  - Assess the TRUE earnings power of the business – “EBITDA”
- **Consider non-operating/non-recurring revenue or expenses such as:**
  - Revenue recognition
  - Non-recurring revenue/expenses
  - Out of period adjustments
  - Sustainability of margins
  - Expiration of key contracts
  - Employment agreements
  - Loss of key customers
  - Asset valuation – accounts receivable & inventory
  - Charitable contributions
  - Excessive owner compensation/benefits
  - Legal defense costs
  - Investment gains
  - CAPEX

Assessing Value Through Due Diligence

Financial Due Diligence - Sustainability?

➢ Quality of Forecast

- Becoming a more critical part of the process
- Can historical trends support future assumptions
- Sellers are usually more optimistic than buyers on achievability
- Loan covenants

Assessing Value Through Due Diligence

Financial Due Diligence - Working Capital

- **Net Working Capital Defined as:**
  - Current Assets – Current Liabilities = Working Capital
  - Typical exclusions:
    - Cash
    - Debt and debt like instruments
    - Income and deferred tax
    - Non-recurring items
- **Often deals are structured on cash free debt free basis**
- **An indication of business health**
- **Can also identify opportunities (e.g., reduce days accounts receivable outstanding)**
- **Important to consider items not on the balance sheet (e.g., bonus accruals, one-time year end adjustments, PTO)**
- **Changes can impact cash needs (rapid growth, slowing economy)**

Assessing Value Through Due Diligence

Tax Due Diligence

- **Tax due diligence is focused on pitfalls as much as opportunities.**
- **Typically, consists of:**
  - Optimal tax deal structure
  - Tax compliance (income and other) and audits
  - Missed opportunities – special deductions, credits, other incentives
  - Open tax years
  - Identification of contingent or off balance sheet liabilities (e.g., payroll taxes i.e., W-2 vs. Independent contractor)
  - State and Local taxes – including State Nexus [HOT ITEM]

If there were Accounting Issues, there is likely to be Tax Issues:

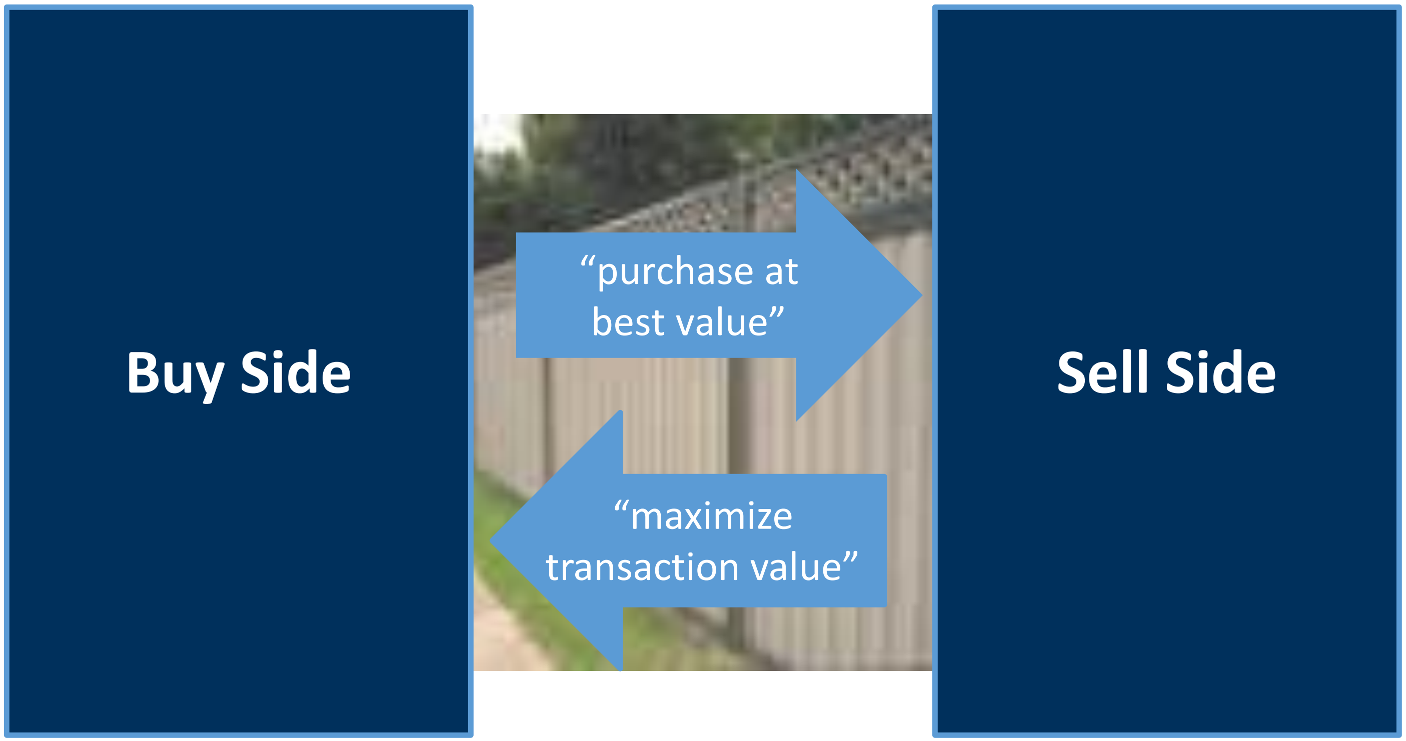
(a) Was taxable income incorrectly reported?

(b) What is the tax cost for the errors(s)?

(c) Ensuring appropriate warranties and indemnifications

Assessing Value Through Due Diligence

What Side of the Transaction Are You On?



Assessing Value Through Due Diligence

Sell Side Due Diligence - Overview

- **As the due diligence process has become more rigorous, Sellers have engaged firms to better prepare them for the process**
- **Time to correct deficiencies**
- **Efforts to position the Company in the best possible light**
- **Differences between buy-side and sell side due diligence**
  - Buy-side attempts to find flaws and use the to buyers advantage
  - Sell-side anticipates these challenges and attempts to position the seller in the best possible light

Assessing Value Through Due Diligence

Sell Side Due Diligence - Benefits

- Anticipate buyers needs
- Avoid post-closing disputes
- Enhanced credibility and transparency of financial and business information to ensure buyer bases offer on key and reliable information
- Address issues before they become deal breakers and/or before buyer sees them
- Formulation of quality of earnings adjustments to present the target in the most favorable light

- Anticipate buyers needs
- Avoid post-closing disputes
- Enhanced credibility and transparency of financial and business information to ensure buyer bases offer on key and reliable information
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- Formulation of quality of earnings adjustments to present the target in the most favorable light

Assessing Value Through Due Diligence

Sell Side Due Diligence – Process Includes

Financial	Tax	Resources
➢ Anticipate buyers needs ➢ Preparation of a quality of earnings and assessment of forecast achievability ➢ Validation of management proposed EBITDA adjustments and identification of other EBITDA adjustments ➢ Organization of financial support for all EBITDA adjustments ➢ Identification of GAAP departures ➢ Analysis of historical working capital requirements including the potential impact of net asset adjustments on working capital requirements	➢ Provide advice with regards to the optimal transaction structure for accounting and tax purposes ➢ Provide analysis of tax consequences and net after tax cash associated with a transaction ➢ Conduct transaction cost studies ➢ Federal, state and local tax compliance assessments	➢ Assist Management with identifying and correcting issues which may lower valuation before the buyer becomes aware ➢ Farrell Advisory can provide project management expertise including managing a secured online data room to help facilitate the flow of deal centric documents and communications with buyers and other advisors ➢ Provide financial schedules for the Offering Memorandum ➢ Assist with the negotiation of provisions in the Letter of Intent and Purchase and Sale Agreement (e.g., warranties and indemnities, and working capital and earn-out targets)

VII. Common Deal Killer Issues During Due Diligence

Common Deal Killer Issues During Due Diligence

Ill-Conceived Due Diligence Leads To Disaster

Due Diligence is an Art and not a Science

Ask the hard questions and demand well-reasoned answers. Ensure that due diligence plays a central role in any acquisition strategy you pursue and you likely will avoid a failed acquisition.

No deal is complete until the Sale and Purchase Agreement ("S&PA") is signed and cleared funds received; then the focus is on post completion work e.g., working capital and opening balance sheet, integration, assessing claims related to S&PA.

Common Deal Killer Issues During Due Diligence

Summary

- **Experienced Buyer and/or Seller Teams**
- **Understanding Strategy for Acquisitions**
- **Valuation and Structure**
- **Due Diligence Process**
  - Financial Due Diligence
  - Taxation Due Diligence
  - Commercial Due Diligence
  - Operational Due Diligence
  - Legal Due Diligence
  - Environmental Due Diligence
  - Human Resources Due Diligence
  - Function-Specific Due Diligence
  - Cultural Due Diligence
- **Mismatch of Expectations**
- **Post Completion Issues**

Common Deal Killer Issues During Due Diligence

Experienced Buyer and/or Seller Teams (1 of 2)

- **Non-Disclosure Agreements ("NDAs")**
- **Project management**
  - Good well structure data room
  - Quality of data (e.g., audited results, adjusted earnings, signed contracts)
  - Too much or too little data and timing of release of data
  - Conflicting data
  - Adequate preparation of management
- **Process takes too long and distracts management from running business**
- **Access to management (not just investment bankers)**
- **Buyer just interested in data collecting**
- **Lack of focus on key issues**

Common Deal Killer Issues During Due Diligence

Experienced Buyer and/or Seller Teams (2 of 2)

- **Buyer unable to manage process/uncertainty with ability to complete**
  - Financing
  - Obtaining approval from stakeholders (e.g., investors and management)
  - Own takeover issues
  - Quality of management and business
- **Balanced Approach**
  - Weaknesses can also be an opportunity
    - Distressed deals
    - Performance improvement
    - Buying "On the Cheap"
- **Look for the right answer, do not just be negative**
  - Too negative, can not find financing!

Experienced and suitably qualified deal team is essential for the successful completion and/or evaluation of an M&A transaction.

Common Deal Killer Issues During Due Diligence

Understanding Strategy for Acquisition

- **Horizontal vs. vertical vs. diversification**
  - Customer segments
  - Products
  - Capability
  - Defensive
  - Synergies
- **Cash flow**
- **Buy and build strategy**
- **Loan to own**
- **Distressed**
- **Opportunistic**
- **Exit strategy**

If you do not understand the acquisition strategy, you can not evaluate the acquisition opportunity

Common Deal Killer Issues During Due Diligence

Valuation and Structure (1 of 2)

➢ Letter of Intent ("LOI")

- Credibility of offer including financing
  - Who has approved offer and financing?
  - What are the "Subject To"?
- Exclusivity period

➢ Valuation/maximize net proceeds

- Advisor costs
- Tax costs
- Estate planning
- Federal and state taxes
  - Delaware Incomplete Gift Non-Grantor Trusts

Common Deal Killer Issues During Due Diligence

Valuation and Structure (2 of 2)

- **Structure**
  - Cash vs. stock vs. earn outs vs. loan notes ($ and timing)
  - Stock versus asset sale
  - Allocation of proceeds
  - Cash/debt free and working capital targets
  - Indemnities and warranties
    - Assessment of protection required
    - Impacts on the desired level of due diligence
  - Escrow accounts
  - Non-competition clauses
  - Management retention
- **Inability to compromise**
- **Approval (or different expectations) of all stakeholders**
  - Buyers (management, Board and shareholders)
  - Financing of buyer
  - Sellers (management being retained, board and shareholders)

Common Deal Killer Issues During Due Diligence

➢ Financial Due Diligence (historical and forecasts)

- Recurring earnings
  - EBITDA
  - Impact on earnings per share
  - Trends in margins and pricing
  - Proof of cash

- Cash flow performance
  - EBITDA as adjusted for CAPEX and net working capital

- Assets and liabilities
  - Inventory ageing and obsolescence
  - Accounts receivable aging
  - Unaccrued liabilities
  - Debt and debt-like instruments (e.g., performance bonds)

Common Deal Killer Issues During Due Diligence

➢ Financial Due Diligence (Continued)

- Contingent liabilities
  - Legal and compliance disputes
  - Post retirement benefits

- Control (financial and business) environment
- Customers
  - Concentration of customer base
  - Stickiness of customers
  - Pricing and terms
- Operational statistics (especially for government contractors)
- Vendors
  - Special terms (e.g., minimum purchases)
  - Changing in terms of trading

Evaluation of the recurring earnings and free cash flows of the business

Common Deal Killer Issues During Due Diligence

Financial Due Diligence (Continued)

- Under resourced business
  - Lack of Capex
  - Lack of investment in infrastructure (e.g., compliance, production facilities, operations, IT, reporting systems)

Taxation Due Diligence

- Past compliance (e.g., S Corp)
  - Understand impact on recurring cash flow (e.g., sales and use tax)
- Hidden liabilities

Commercial Due Diligence (External factors impacting business)

- Present and future market conditions and growth expectations
- Competitive landscape
- Changing customer requirements
- Technology threats
- Government funding

Common Deal Killer Issues During Due Diligence

➢ Operational Due Diligence

- Customer base
- Vendors
- Operational enhancements and synergies
- Operational facilities and premises
- Capacities
- Investment required

➢ Legal Due Diligence

- Litigation
- Contractual arrangements (e.g., assignment of contracts)
- Intellectual ownership
- Impact of brand
- Property

➢ Environmental Due Diligence

Common Deal Killer Issues During Due Diligence

Human Resources Due Diligence

- Adequately compensated and incentivized workforce on a go forward basis
- Benefit plans and post retirement plans
- Union recognition
- Capabilities of the management team and employee workforce
- Employment contracts (e.g., change of ownership clauses)

Function-Specific Due Diligence

- Government contracting
- Healthcare
- Energy

Cultural Due Diligence

- "Rock Star" vs. "Team" approach
- International transactions

Common Deal Killer Issues During Due Diligence

Due Diligence Process (6 of 6)

Good communication between members of deal teams essential so that can deal with due diligence by either withdrawing from process or via:

- ✓ Price reduction
- ✓ Structure (cash vs. stock vs. earn-outs vs. escrow accounts)
- ✓ Legal protection
- ✓ Insurance
- ✓ Corrected via merger integration/performance improvement initiatives
- ✓ Assessment of findings (e.g., cost of putting right or integrating business and impact on projections)

Common Deal Killer Issues During Due Diligence

Mismatch of Expectations

- **Timing of doing the deal**
  - Seller sees performance improving
  - Distressed deal
- **Valuation and Sale and Purchase clauses**
- **Capabilities of business**
- **Performance**
  - Versus forecasts
    - Importance of making sure you meet your initial forecasts which can be assessed during the due diligence
  - Adverse change in business trading
  - Working capital shortfalls
- **Legal issues**

Need to understand own and other party's expectations quickly so that you can improve your negotiation approach and/or not waste time and expense

Common Deal Killer Issues During Due Diligence

Post Completion Issues (1 of 2)

Management

- Willingness of management to stay
  - Access to customer base
  - Technical expertise
- Weak management

Integration costs

- Costs of RIFS and restructuring

New working capital requirements

Synergies

- Target's market growth is lower than expected
- Industry margins are less than expected
- Target's market position is weaker than expected
- Pricing of common customers may trend to lowest pricing terms

Common Deal Killer Issues During Due Diligence

Post Completion Issues (2 of 2)

- **Culture**
  - Understand how to manage business post completion
- **Change of control issues**
  - Shareholders (i.e., minority incentives especially on government contracts)
  - Contracts
- **Competition/anti trust issues**
  - Competition is tougher than expected

Acquirer expects changes post acquisition but does not want to keep waiting for changes to come.
Be decisive on integration actions. based on good information and conclusions.

VI. Wrap Up and Questions

Questions

VII. Contact Information and Biography

Farrell Advisory

David Farrell, President

David Farrell

Professional Involvement:

- The Institute of Charted Accountants in England and Wales (Qualified as Chartered Accountant and in Corporate Finance).
- Association of Insolvency and Restructuring Advisors.
- Association for Corporate Growth ("ACG") National Capital (Membership Committee).

Community Involvement:

- Board Member and Former Treasurer, Higher Achievement.
- Board Member and Treasurer, National Capital Poison Center.
- Board Member of Capital for Children.

David Farrell has over twenty years of experience in Transaction Advisory Services (buy-side and sell-side due diligence and carve-outs) and Restructuring & Business Reengineering either as a consultant (Partner and Managing Director) at Big 4 (KPMG), international consulting practices (FTI Consulting) and national accounting firms (Cherry Bekaert, a Baker Tilly network firm) or as principal (CFO or Strategic roles) at European listed and Management Buy-Out ("MBO") businesses, covering both the strategic as well as the transactional side of the business, with deep knowledge of the U.S., European and emerging markets. Among David's achievements are:

- Led over 130 transactions with revenue exceeding $67 billion across multiple sectors and countries with companies ranging from small to very large, from family owned to publicly listed, from local to multinational corporations.
- Significant experience in technology and telecommunications, government contracting and defense, manufacturing (industrials), distribution, asset rental, residential construction, health and energy and business service sectors.
- Performed over 22 significant U.S. engagements (e.g., buy-side due diligence, business diagnostics and performance improvement) in the government contracting sector including multi-million dollar performance improvement engagement to multi-billion global government services provider in support of U.S. national security and foreign policy objectives.
- Extensive experience helping companies improving their performance, increased efficiency and reduce cost of production/delivery of service.
- Led 18 creditor and debtor side restructuring and business diagnostic engagements (revenues in excess of $14B) assisting SunTrust (LandAmerica), Bank of America, Lewis & Bockius, counterparties of Vitro, S.A.B. de C.V., Landis Rath & Cobb, and Kodak with their strategic options.
- Led and performed three major sell-side and carve out consulting engagements for Sara Lee, BP and Delphi.
- Served in multiple CFO and strategic roles with focus on performance improvement, merger integration, carve outs of non-core businesses and alignment of management's remuneration with shareholders' objectives.
- Managed the disposal of a listed company, with over $500 million of revenue in technology and financial services businesses, the repurchase (and subsequent sale of several businesses) of the technology group of businesses via a Management Buy-Out vehicle and a reverse take-over of a AIM listed technical training business.

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