

TABLE OF EXPERTS

Mergers & Acquisitions

BY HOLLY DOLEZALEK, CONTRIBUTING WRITER



The Minneapolis/St. Paul Business Journal held a panel discussion recently on mergers and acquisitions. Panelists included Ryan Turbes, a partner and CPA at Boulay; Dan Weninger, vice president of commercial banking at MidCountry Bank; Kylie Kaminski, an attorney at Hellmuth & Johnson; and Sam Thompson, president of Transitions In Business. Dyanne Ross-Hanson, president of Exit Planning Strategies, served as moderator.

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**MODERATOR****Dyanne Ross-Hanson**
Exit Planning Strategies

Dyanne Ross-Hanson is president and founder of Exit Planning Strategies, a firm dedicated to helping business owners navigate the most significant financial transaction of their lives: exiting their business. She works with owners and their advisory teams who are three to 10 years from divestiture in capital and/or contribution. Helping to evaluate options and to create an action checklist so that owners can depart on their terms, to their party of choice, and for the dollars they deserve.

**PANELISTS****Kylie Kaminski**
Hellmuth & Johnson

Kylie Kaminski is an M&A attorney at Hellmuth & Johnson. She represents established and emerging businesses entities with acquisition and corporate law needs. Kaminski believes there are many roads to success and she carries that attitude throughout her practice. She brings innovative solutions to her clients and makes sure she asks the right questions to help them tackle their specific goals. Prior to joining H&J, Kaminski worked at a tax firm focused specifically on commercial real estate. She draws on her time and experience in investment banking to advise clients with their business needs. Clients appreciate her proactive demeanor and the individualized service she provides them with. When a client walks in the door, she makes sure they know the work she is doing for them is top priority. She is licensed to practice in Minnesota state courts.

**Sam Thompson**
Transitions In Business

Sam Thompson, president of Transitions in Business, has successfully guided countless business owners through the sale or merger of their businesses for the past 10 years. He is a certified business intermediary, as well as a merger-and-acquisition master intermediary. Prior to becoming an intermediary, Thompson was a CEO and business owner for 29 years before selling his \$16 million business. Transitions in Business specializes in selling privately held business-to-business, health care, transportation, hospitality, manufacturing, distribution and construction/trade services businesses with a minimum revenue of \$3 million.

**Ryan Turbes**
Boulay

Ryan Turbes is a partner and certified public accountant at Boulay and enjoys delivering critical transaction insights that help clients make investment decisions and analyzes business operations for improving performance. With a focus on search funds, private equity, family investment offices and corporations, he offers transaction advice and services helping buyers and sellers make timely informed decisions. He also specializes in providing tax, attest and accounting services to private and ESOP-owned clients in a variety of industries. In his free time, Turbes enjoys spending time with his family, hunting, fishing and golfing. He is an active member of the Saint John's University Alumni Association board of directors and Coalition 9 Leadership Community.

**Dan Weninger**
MidCountry Bank

Dan Weninger is a seasoned commercial banker who built his career in several large metropolitan areas across the Midwest before joining MidCountry Bank seven years ago. Weninger's tenure allows him to practice the art of his craft: finding creative ways to structure deals. His consultative approach facilitates securing necessary financing, but also anticipating broader banking needs of the growing business, sometimes before they even know they have them. By bringing the recommended services or financial management tools to the table at the right time, Weninger adds value to the relationship in ways that are often not measured. He is particularly effective with leveraged lending or private equity sponsored financing arrangements.

Dyanne Ross-Hanson: Last year, when our Table of Experts came together, we were talking about the unique challenges that the pandemic posed and its impact on mergers and acquisitions. In calendar year 2021, both U.S. and global M&A activity easily surpassed pre-pandemic levels. With U.S. deals accounting for almost \$3 trillion in transactions in 2021, up 55% from 2020. And M&A activity is poised to climb even higher in 2022. In spite of this optimism, there remains challenges in the marketplace. Sam, how have you seen the supply-chain disruption affecting merger-and-acquisition transactions?

Sam Thompson: The sellers I'm working with are increasing their inventories. When they're normally having inventory for three months, they now may need it for six months. This affects their working capital. Increased inventory, combined with rising costs, could cost the seller more at closing as the buyer may insist on higher working capital to get through the next year. Buyers are doing much more due diligence relating to vendors and suppliers. They're insisting on multiple suppliers now; if a business has just one supplier for a certain product, that could cause an issue with the transaction.

Ross-Hanson: Dan, how much senior debt will the bank typically provide in an M&A transaction?

Dan Weninger: It depends. What does the balance sheet look like post-closing? A 50% equity/50% senior debt with no mezzanine debt may be a reasonable structure. If equity makes up 35% to 40% of the transaction, the senior lender will traditionally lend a similar amount with a mezzanine lender rounding out the rest of the transaction.

Ross-Hanson: Ryan, in your experience, what have been the most common reasons that deals expire?

Ryan Turbes: Each deal has its own unique challenges, but mismatched representation is certainly a significant one that can be a significant challenge to overcome. Making sure that you get the right players on your team, either buy or sell side, people who have experience in the transaction space is critically important. Some other common reasons why deals expire include seller remorse, due diligence findings; specifically, sales and use tax; customer/vendor concentrations, related parties, changes to revenue mix and the net working capital expected to be funded at close. Lastly, clarity of your Letter of Intent ("LOI"). If you have a solid LOI, then both parties already have an understanding and agreement on key transaction items such as tax and entity structuring, escrow expectations, payment terms, and funding commitments, all of which could lead to more closing certainty.

Thompson: Surveys with M&A professionals throughout the country have found 90%

of buyers that begin the process don't follow through. Once there is an agreement in place, such as an LOI, then the percentage drops to about 50% of the deals that don't happen.

Thompson: What are you seeing for closings once an LOI is in place?

Kylie Kaminski: The LOI generally has the top ticket items; if those terms get agreed to in the beginning, I would say that nine out of ten LOIs that cross my desk get to close.

The shorter the LOI, the more hard-hitting the items. We've gotten a lot of first-time clients who say, "We're doing an M&A deal and our attorney has no idea what they're doing, and we need help." That's been a positive outcome of the challenges of the past year, businesses are understanding that subject matter experts are a good idea, especially in M&A.

Obviously, the latter is a bit more difficult, especially not being able to negotiate items that we may recommend a client would not want to agree to.

Most of the time, we get a deal at the LOI stage where negotiations can still happen. In some cases we get clients saying, "Hey, we signed this LOI, can you do this for us?" Obviously, the latter is a bit more difficult, especially not being able to negotiate items that we may recommend a client would not want to agree to, but I would say nine out of 10 LOIs that cross my desk go to close.

Turbes: Our percentages are similar. Maybe not quite as high as 90%, but they're higher than 50%.

Ross-Hanson: Dan, the Federal Reserve has indicated their intent to gradually raise interest rates this coming year in response to inflationary pressure. For those acquirers relying on debt financing, do you anticipate any impact on deal volume or timing?

Weninger: The question today is whether the Fed will increase rates by 0.5% or 0.25% in March. They don't want to shock the market by coming out too strong, but they need to get inflation to a more manageable rate. With that said, I do not see deal volume slowing down in 2022. We will continue to be in a low interest rate environment, and investors will continue to take advantage of that.

Ross-Hanson: What about the covenant structure in a typical M&A?

Weninger: We always want to see strong cash flow. We are going to want a fixed charged coverage ratio and typically will want a cash flow-leverage test. Out of the gate the balance sheet is leveraged. We want to see leverage come down. In addition, we also will require compliance certificates to allow us to test the covenants on a quarterly basis.

Ross-Hanson: Ryan, how have you seen the M&A marketplace change over the past couple of years when it comes to due diligence?

Turbes: Besides the sheer volume in this



frothy market, we have witnessed a significant shift in how we perform our due diligence. We are now substantially performing all of our due diligence remotely and are only visiting target company's at the request of the buyer or if we are unable to use technology to efficiently and effectively complete our diligence. Sellers have been more willing to engage us to perform sell-side diligence. This allows the seller to gain an understanding of those potential financial areas that may concern a potential buyer. Performing a sell-side diligence can lead to a higher certainty to close.

Ross-Hanson: Kylie, tell us a little bit about earnouts. How do you see those impacting deal success rates?

Kaminski: Throughout the pandemic, there were a lot of inflated numbers on businesses books, and buyers were really wondering, is this target company actually worth it? With that in mind, buyers built in earnouts based upon the financials to get to the valuations

that sellers wanted. With an earnout, a seller has the opportunity to make an exponential amount if the balance sheet stays and maintains what is currently on its books. We saw that a lot of these in the past year, and pretty significant earnout amounts, well into millions of dollars. Pre-pandemic, there weren't a whole lot of earnouts in typical M&A, this was generally reserved for more volatile industries. With the pandemic last year, it seemed to be that a lot of founders said they will happily stay on for a certain period of years, in exchange for more money. It is interesting as it can be a way to keep founders at the company longer than a typical transition structure.

Thompson: I tell sellers, if you're going to agree to an earnout, base your total anticipated payment on cash and guaranteed money such as a promissory note. If you do get any earnout money, that's great, it's a bonus — especially if they're selling and won't be involved in future management decisions. You're

relying on the buyer to hit your numbers. There are so many different ways you can structure an earnout. I tell owners, if you're going to agree to one, at least do it based on revenue and not net profit. Revenue is what it is, whereas net profit can be affected by unnecessary expenses.

Kaminski: And our recommendation has been, that if a founder is going to agree to an earnout, to at least stay at the company for the full period of the earnout so they can have a little more access and control. We did see a lot of that, and most founders did stay on. I think it has become a way for founders to limit their hours, and retire early, at a higher valuation, without fully retiring now.

Ross-Hanson: Ryan, what is net working capital and why is it an important part of any deal?

Turbes: Working capital is the liquidity a company needs to fund its short-term obligations (payables and payroll) during the period it takes for the revenue cycle to generate cash.

Net working capital can be one of the least understood yet more complex areas of the transaction. For example, if you have a business that's growing exponentially fast, instead of using a trailing 12-month average to set the net working capital peg, you may want to consider using a trailing 3-month average. To take it a step further, if a Company is invoicing its customers on the first of the month and you close the second day of the month, there could be a material change in the net working capital delivered at close when compared to what the net working capital peg was set at.

Ross-Hanson: Dan, tell us a little bit about whether senior lenders are willing to provide lines of credit for working capital in an M&A transaction.

Weninger: Preferably, we want the company to have access to some liquidity. Historically, we provide that in the form of a working capital line of credit. The line will be governed by a monthly borrowing base certificate.

Thompson: As far as how working capital is negotiated, it depends on the size of the deal. With the smaller deals it oftentimes is built into the loan. With the larger deals, the buyers are typically expecting the seller to leave some money in the business.

Ross-Hanson: Kylie, rep and warranty insurance. Can you comment on that, as well as any other hot-button items?

Kaminski: Representation and war-

ranty insurance is something we've seen a rise in over the past year, especially with mid-market to higher deal prices. It has become more accessible for both the buyer and the seller with high valuation targets, as the prices on the premiums have gone down. For a buyer, they have ability to recover directly from an insurance company rather than the seller, especially if the founder is staying on and the buyer wants to preserve a good relationship with the founder. The general thought from a buyer is that they don't want to sue the guy who's working for them because something's wrong with the business — they want him to keep working on the business side of things. I don't think rep and warranty insurance is as prevalent on smaller deals, just because the premiums can be high and sometimes it just doesn't make financial sense. The other thing we've really seen a lot of is an "F" reorganization for tax purposes. An "F" reorganization is where a target company, that is a corporation, converts into an LLC, and then a holding company is formed to own the new LLC, and the holding company becomes the seller. This type of restructuring pre-sale has been a hot-button item we've seen in the past year, especially for a buyer where the perks of the PPP staying with the company and the liabilities has been a consideration.

Turbes: Kylie, what about the qualified small business stock gain exclusion under Section 1202? We have observed a significant uptick in buyers considering their tax structure pre-close to potentially be eligible for Section 1202 upon a liquidation event.

Kaminski: Generally a buyer will want the target to be a Qsub or an LLC, so it's easier for the buyer to purchase a disregarded entity. But a lot of buyers have been using an acquisition vehicles that are owned by a C corp in some capacity.

Ross-Hanson: Ryan, you referenced Section 1202. Tell us what you're talking about.

Turbes: Section 1202 of the Internal Revenue Code was enacted to provide an incentive for investment in startup corporations. In its current form, Section 1202 allows the exclusion of 100% of the gain realized on a sale of qualifying small business stock. For more information on this area please visit boulaygroup.com/qualified-small-business-stock-gain-exclusion.

Ross-Hanson: Sam, is it ever wise to begin the deal process with one buyer?

Thompson: It really puts you at a

disadvantage when you're talking to just one buyer. You give that buyer all of the leverage. Ideally, the best transactions are the ones where you go through a process and a pool of buyers is created resulting in a bidding war. Sellers are concerned about confidentiality, and I get that. Yet, should your one buyer drop out, you are left starting over. With a pool of buyers, you've got your backup plan. If things don't work out, you can go back to the buyers-in-waiting.

Kaminski: I had two deals this year where the buyers fell through and the seller got a new one from the auction process of having multiple buyers. It's a great idea to have more than one. This can also be a mechanism to drive the price up for the seller.

Ross-Hanson: Are there any opinions on when an owner asks, "Really? Do I need all five advisers at the table? How much is this going to cost me?"

Kaminski: The best answer is that the seller gets the subject matter expertise that you really need in an M&A deal. As an attorney, I could not do what Ryan — a CPA — does, with respect to the in-depth financial analysis. Most

of the time when people call me, they say, "My attorney told me this." But frequently that attorney does not do what I do. That's where the value comes in of those five people, specialized in depth attention and focus only on M&A. It might spread the cost out for the seller a bit further, but it's worth every penny.

Thompson: It's money well spent. Companies that take on an adviser or a coach two to three years before their exit sell faster, and typically, I'll be able to get them a better price.

Turbes: Entrepreneurs may only get one "bite of the apple" or one chance at a material liquidation event that provide significant wealth to your family or future generations up. At the end of the day, you get what you pay for. I have had conversations with sellers who did not understand the net cash impacts when they sold their business, and if they had just reached out to the right people to simply ask for help, they could have had more net cash in their pockets even after paying all of their advisers. Get us involved early in the process; we want to Help You Get There.

Ross-Hanson: Harvard Business Review did a study that said that



between 70% and 90% of mergers and acquisitions fail. That is suggesting that 10% to 30% of M&A that go to market result in a successful transaction. Dan, how do companies, business owners, and their teams increase the odds in their favor?

Weninger: The existing manage-

ment team is key to the success of the transaction. If the seller is stepping away on day one, the management team really needs to have been running the day-to-day operations for a period of two to three years prior to the sale. If that isn't the case, the buyer will need a plan, which may include bringing in a strong management team. Sometimes



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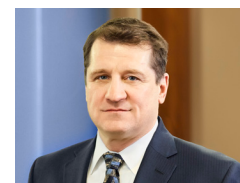
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Ross-Hanson: Kylie, how do you think business owners can best prepare for a transaction, and when do they start?

Kaminski: I guess I would say from a legal perspective, the best thing a seller can do to prepare is to get the due diligence documents in order. Those businesses that have all of those documents in one place have less stress and can get the process done quicker. Those are good business practices that entrepreneurs should be doing anyway. The sooner business owners can get their documents together, in whatever capacity — whether that’s online or a digital system — I think even when a founder starts to think about getting ready to sell, preparing that is going to be huge. That’s the biggest stressor that I’ve found with sellers is, getting all the requests for the buyer put together, and also running the day-to-day of the business.

Thompson: The main issue with many businesses is that the owner is too attached. They can’t take a vacation for four weeks and come back to a business that is just fine or better. They real-

ly have to remove themselves from the business and have created a good management team that believes in what the company is doing, because the buyer is not buying the owner; they’re buying the business.

Weninger: It’s one of the first questions I ask: Is the management team ready; how are you going to incentivize that management team to stay if the seller is stepping away on day one?

Kaminski: I’ve seen it where it’s a requirement of closing that the management team stays on, and the founder or other key employee is signing some kind of employment or consulting agreement.

Weninger: It might be that the seller is just taking risk off the table and they’re selling majority ownership of the company.

Ross-Hanson: Sam, what should a business owner do now to get ready for a future sale, and when should they inform their key management team of their intent?

Thompson: The best thing an owner can do is get their financials in order. Clean up personal expenses charged to the business. They should start that

three to five years in advance. It’s critical to be able to respond to a buyer as quickly as possible with good, solid numbers that match up and make sense. The best situation is to delay telling any employees until the business has been sold and money’s in the bank. That’s really tough to do. With larger transactions it’s almost impossible, because you need to include your key people to help with presentations and due diligence. But if word gets out that you’re selling, you may have problems maintaining employees, customers and vendors.

Ross-Hanson: Ryan, when do you think business owners should engage their service providers or advisory team in anticipation of a sale?

Turbes: If we are going to be engaged as the buy-side accounting firm, then we typically prefer to, at a minimum, start having discussions pre-LOI. This can allow for the respective buyer to get comfortable with the target’s financials or potentially get some things into the LOI, or have some of those difficult conversations with the target before you even sign that LOI. If a company is considering going to market, then we typ-

ically prefer to be engaged as soon as possible. If you can, start that process now, so that you can learn from and apply any diligence findings immediately to your monthly financial reporting package.

Ross-Hanson: Is there anything that any of you would like to share in closing that you have not discussed already?

Kaminski: We all have stressed the importance of getting the right people on your team. M&A is really a team game.

Thompson: It’s an exciting time for mergers and acquisitions, and it’s going to be an active year. The tsunami of baby boomers selling just hasn’t happened because the boomers want to keep working. But I think it might be starting. I think Covid’s done a number on them, and they’re ready to move on and sell their business.

Weninger: I agree with you, Sam. We’re going to see it in the next three to five years. It’s going to be crazy.

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