

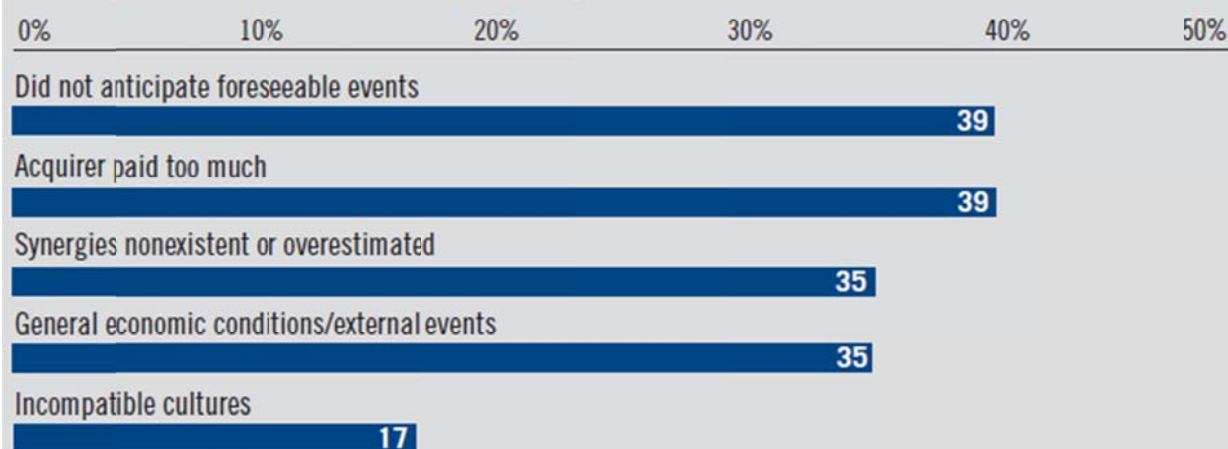
## Introduction

Mergers and acquisitions are the best of times and the worst of times. Your first merger and acquisition is going to be the culmination of all the work you've been doing for years, so it's the sweet payoff that you've been waiting for. But, it's also a nightmare that will last what seems like an eternity because the lawyers and accountants will ask you to provide a receipt or contract for everything from your underwear to the trademark for your logo that was domiciled in Delaware.

### EXHIBIT 1

#### Reasons for M&A failures

% of respondents' reasons for unsatisfactory mergers



## Merger & Acquisition Timeline

1. Teaser information is disseminated for lead generation.
2. First contact with interested buyers is established.
3. Signed Non-Disclosure Agreements ("NDAs") are provided.
4. Financial statements for current and historical information are provided to potential buyers. Buyers will usually focus on current information. You shouldn't provide information related to the company's future prospects yet, such as projections and sensitive trade secrets.
5. Negotiations – If it takes longer than a month, then things are not going well. It's common for both parties to walk away multiple times before an eventual deal is made.
6. If you've reached the point where negotiations have shown that buyer is imminent or more likely than not to buy, then trade secrets and future projections should be shown.
7. Due Diligence – This is the last part because it's expensive to hire lawyers and accountants. If you hired professionals and have all the info ready it will be between 3 to 14 days. If you're disorganized then it's whenever you get your act together or when the buyer backs out. I've seen deals that took 8 months of due diligence. The cost is shared between the two parties.
8. Closing – Could take days or months depending on how you've decided to transition. Usually, you'll try to get the check cut and run as soon as possible, but it's not always possible.

## Starting the Negotiations

The entire M&A process begins with the distribution of white papers. White papers are marketing advertisements distributed to garner interest from buyers with teaser info. Usually, this includes very general revenue estimates and vanity metrics. Examples of vanity metrics are the number of tweets per second for twitter. The number is impressive but has no meaning or bearing on the business model or its ability to generate income.

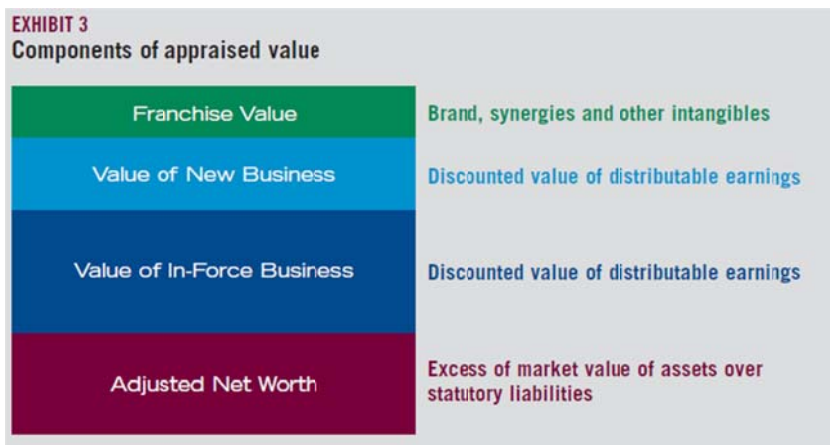
When you have a fish on the line, the buyer would contact you to for additional information and negotiations. At this point, if you sense that the buyer has a realistic want and ability to purchase your company, then a NDA is signed. Current and historical data is provided to the buyer to understand the business. This is comprised of financial statements. You provide a good deal of confidential information at this point, but you're still careful to mind your sensitive "trade secrets." Most buyers are honest and have integrity, but there's always the off-chance that you'll be dealing with an unscrupulous character. Opening your business' kimono could be dangerous because they could use your experience and knowledge gained by feigning interest buying your business to eventually become a direct competitor.

## Finding Your Multiple

This is the point where negotiations begin, you and the buyer talk about evaluations and "multiples of EBITA" plus the fair market value of company assets. The buyer is trying to set a price for your company and you're both negotiating for the best price. EBITA is "earnings before interest, taxes and amortization." EBITA is best understood as the net income after direct business expenses.

EBITA Example:

Gross Revenues
(Inventory)
Net Revenues
(Rent)
(Employees)
(Contractors)
(Office Supplies)
(Advertisements)
(Meals and Entertainment)
EBITA



After determining your EBITA, you'd negotiate the multiple of your business. Usually, the multiple grows concurrently with your EBITA. The greater the EBITA per year, the greater your multiple on the sale. The relevant ranges are going to be 1 to 3 million, 3 to 5 million and etc. Deals that have revenues less than 1 million per year are best sold through personal networks or by speaking to direct competitors because the average buyer or investor isn't going to know enough about your business to properly evaluate your company's assets.

Businesses with EBITA greater than 1 million are better off looking for a broker that has had experience in selling similar properties or businesses. A broker has a built-in network of buyers, so they're usually able to get you the best deal possible. An effective broker with the relevant experience will provide anywhere from a 30% to 300% of your sale price without one. It's important to know that a broker that has experience selling businesses in your industry alone isn't enough. The broker has to have experience selling companies with the same EBITA. If they're used to selling small companies or fortune 500 companies, then they won't have the network you need to maximize your sale!

After you've negotiated the entire deal, you get into the "due diligence" where both parties hire their accountants and lawyers to check everything. This is usually a quick process because deals are babies walking on egg shells. You never know when the buyer might wake up with the jitters and walk away from the deal along with your payday. Professional shops will close the due diligence in timeframes between 3 to 14 days if all information is provided depending on the size of the deal. The accountants and lawyers won't sleep during this time because they'll be working 24 hours a day until the deal has gone through. But, I've also heard of situations where this process has taken 6 to 8 months because the seller was unable to produce the information quickly enough.

After the deal is closed and the due diligence is cleared, there is usually a period of time that could take up to a year before the deal is closed. This is the time it takes for everyone to meet and work out all their issues before the company's assets are officially turned over and you get a bank wire for the funds.

## The Due Diligence

Due diligence is the part where everyone needs to turn over every rock to make sure that we've all been honest and that all our assumptions about the company and the buyer's finances are above water. Caveat emptor means "buyers beware" in Latin and is referred to very often in law because once you've paid for the business; it's really hard to get that money back.

This is the most important part of the M&A process because this is the time where the buyer is waiting for the report stating that the business is good to go and that it's a great purchase in the lawyers' and accountants' opinions. You're trying to get all the paperwork and answer all the questions that the lawyers and accountants are asking so that you can get this deal signed. The quicker you get through this process the better the chance of the deal going through.

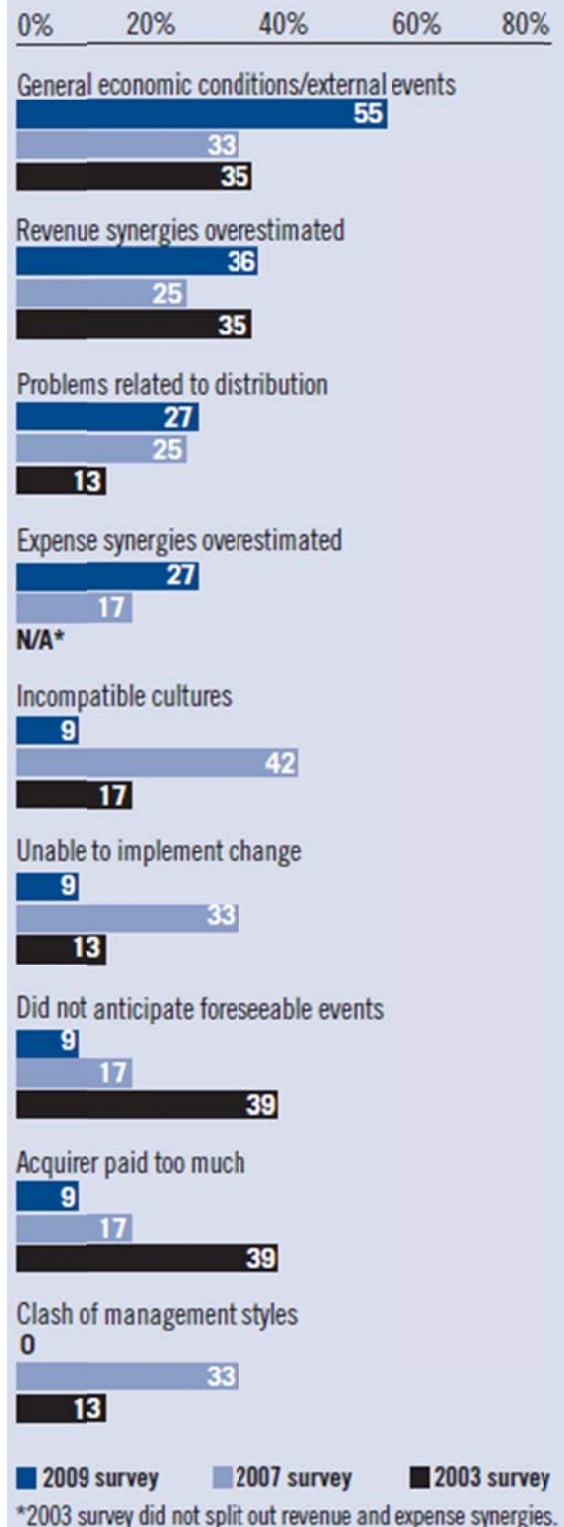
In my experience, I've seen more than 70% of deals break down after two weeks because the buyer starts to get scared and is wondering why this seller is taking forever to give me this information. The seller must be doing something wrong otherwise the due diligence should've been done already.

Note, you should've been preparing for this event, since last year. If you've walked into the process half-assed, then you're going to have it handed back to you on a platter.

What actually happens during the due diligence period?

### EXHIBIT 6

#### Problems Encountered in M&A Transactions That Did Not Fully Meet Expectations



1. Examination of the potential target's (Your Company) current financial condition for merger or acquisition.
  - a. Checking for title and ownership rights to all relevant properties;
  - b. Checking for the actual existence of assets on your books;
  - c. Checking tax returns for unrecorded liabilities; and,
  - d. Checking financial statement audits.
2. Reasonable investigation focusing on the future.
  - a. Checking your client list
  - b. Lifetime Value of Customer
  - c. Checking your client's tendency to repurchase
  - d. Possible regulations or market conditions that could affect the business
3. Checking the valuation's basis and model for appropriateness of the cost.
4. Asking questions about the business for possible issues that require additional attention.

## The "Official Framework" That the Industry Uses:

1. Compatibility audit.
2. Financial audit.
3. Macro-environment audit.
4. Legal/environmental audit.
5. Marketing audit.
6. Production audit.
7. Management audit.
8. Information systems audit.
9. Reconciliation audit.

Obviously, depending on the size of the deal the amount of due diligence will vary. The bigger the company, the more due diligence you'll need to have in order to check everything. I've seen due diligence costs starting at \$40,000 dollars for deals that involved an evaluation of \$1 million dollars. Due diligence is required for investments into startups as well.

## How to Prepare?

You should be preparing a year in advance for the sale of your company because you need to make your financial statements as amazing as possible to get the best possible price for your company. You'll need to "trim the fat" by any means necessary.

The most common ways to trim the fat to maximize short-term income for the current year is something should learn from the big dogs like Mark Hurd, the ex-CEO of Hewlett Packard.

1. Layoffs – salaries are your single greatest expense for almost any company. Each employee is a sizable chunk of your business, so each employee that isn't pulling their weight would mean a huge amount of savings. Mark Hurd habitually laid-off entire divisions or the bottom 10% of employees based on year-end evaluations. This resulted in amazing profits for the current year, but a demoralized and overworked salaried-staff.

2. Services – Another option to layoffs is converting employees to independent contractors. An employee costs 150% of what their gross salaries. You could pay the employees 110% of their salaries based on independent contracts and still be saving money.
3. Renegotiating long-term contracts – everyone is used to signing up for long-term contracts to cellphone providers, landlords and etc. A rule of thumb is that the longer the contract, the cheaper the cost. You could renegotiate contracts to decrease the cost for expenses in the early years and then recoup them in the later years. This could help raise the bottom line in the short-term.
4. Reviewing expenses – if you give employee reimbursements and/or spend a good amount on office supplies and etc. Requiring paper expense reports will probably decrease your costs by 15% immediately because of failure to properly retain receipts and laziness.

The above strategies aren't popular with your employees because you're effectively killing the morale in exchange for the short-term cash. But, I've personally dealt with situations where I've been frank and open with the employees about the changes. They understand that the company is getting poised for sale so that they're all working together to get the business ready and that the benefits of the windfall will be shared by everyone as well.

Besides getting the current year's financials in order and saving on costs, you'll need to start creating paper trails that can be easily auditable. Every single thing that happens in the company and every single asset needs to be documented.

## **Most Common Mistakes:**

Written Content – Proof that a transfer of copyright to written articles or blog posts exists. Copyrights are vital to content distribution businesses because copyright trolls are a growing concern. Patent trolls have been successful in creating business models for major businesses to pay healthy license fees for their portfolios. Trolls have taken the business model and expanded into copyrights.

Intellectual Property – IP needs to be protected because it's an invaluable asset. We'll need to see that any independent contractor and employee that have been working in the company has a clause stating that all intellectual property is owned by the company or a contract transferring its rights. The best option would be to have a patent or at least have it pending, but this isn't absolutely necessary because it is costly.

Taxes – Taxes is a fundamental issue that every merger and acquisition will always have a hiccup. I've never seen a single deal that has had a perfect tax write-up. This is great news for you because it's alright to make mistakes, but it's not alright for you to be completely FUBAR. Examples are sales and use tax. Everyone usually pays sales tax, but most people forget about use tax. Use tax is charged when you buy assets outside the state and employ it within the state. Sales and use tax goes together because they're always the same rate and they're written so that they mirror each other. Personal property tax is another one that everyone misses.

Accounting – The problem is that there is no accounting. You don't have any records or bookkeeping process to account for any of your transactions. Your idea of accounting or bookkeeping is the amount of revenue shown in your bank statement, paypal account or some other finance institution. This is never acceptable. If the company is being sold more multi-million dollar price tags you better bet that the buyer is expecting audited financial statements.

Once you've gathered all of the documents to prove your financial statements, assets and illustration that there isn't potential legal liability. Then this portion of the process is complete after the lawyers and accountants issue your due diligence report.



## The Closing

Closing can be done in a variety of forms. There could be a cash payout that results in a bank-wire of an outrageous sum, where you pretend that you've just won the lotto. But, this isn't always the case. The closing is wholly dependent on how you decided to structure the deal during the negotiation phase to maximize your multiple. The multiple is what investors or VCs are always talking about in 10x. The multiple is the number of times the buyer will multiply your EBITA for your business.

Maximizing your multiple is done by relieving the buyer of risk or allowing them to finance the buyout somehow that would spread the cost overtime. The most common way people increase their multiple is by making the deal into a payout or allowing the buyer to pay the sum in installments.

Payouts lower the risk because your multiple is tied directly to the business' performance in the future. You agree that if the company meets certain sales or growth goals, then you get the higher multiple. On the contrary, if you miss the targets, then your multiple goes down. Installment agreements spread the payments across multiple months or years. This makes the deal self-financed. The deal won't cost the buyer much from their own pockets and reserves, so by putting as little as 3% of the total cost down they're able to buy the business and use the profits pay for the business. This lowers the overall cost of the purchase to the buyer because they're able to move forward without using debt or credit and pay interest to lenders. This is true for payouts as well.

Depending on whether you negotiated the sale to maximize the multiple or for the cash upfront will make a big difference on how long the closing take. But, even after the closing it could take a while for you to actually remove yourself from the business. The contract could stipulate that you remain with the company for at least 3 years (as in the case of an acquihire) and your payout would obviously become less if you voluntarily leave earlier than the agreed time. Note that being laid-off would still get you the full payout, but getting fired wouldn't.

Also, the buyer may require that you transition the business over the next 6 to 12 months to help make sure that the process goes smoothly without affecting the operations. There are a variety of possible scenarios that you could face, but these are the most basic outcomes.

## Conclusion

It's important to note that the due diligence process is important because the dot-com bust in 2000 taught us that over-valuation destroyed companies. Sellers during the dot-com era were able to obtain favorable valuations. Today, buyers and sellers are pricing the companies with greater efficiency because of the due diligence process, so it's important to make sure that they're handled right to maximize the value of your business.

More than 50% of mergers and acquisitions are failures that CEOs regret. The exhibit will illustrate how executives felt about their mergers and acquisitions in retrospect.

### EXHIBIT 5

#### Success of M&A Transactions During Past Three to Five Years Relative to Expectations

