> Seven M&A Documents Demystified:

An Entrepreneur's Guide to M&A Success

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> Introduction

Prior to and during the course of selling a company, buyers (strategic buyers, financial buyers, lenders, investors) will require business owners to produce and (in some cases) sign many documents.

Some of these documents are marketing documents that present the business (teasers, confidential information memorandums, PPMs, Executive Summaries, etc), some are information requests (updated financial information, customer contracts, customer data, etc), and some are actual legal documents that must be reviewed carefully and then executed.

Knowing how to prepare, produce, and review all of these documents is a skill set all unto itself, which is why most entrepreneurs who have built valuable businesses always retain the help of a banker, broker, lawyer, and accountant instead of trying to do it all on their own.

AxialMarket's in-house research team has assembled a collection of articles that summarizes the most essential components of key M&A documents that business owners encounter throughout the transaction process. This white paper dives into the documents needed to prepare your company to be marketed to buyers, summarizes the elements in the key IOI and LOI documents, and provides an explanation of important contract terms that are commonly encountered.

In this white paper, you'll learn:

- How to write great teasers that attract interest from the right buyers
- Marketing materials you'll need to sell your company
- Three key items to negotiate in the NDA you'll sign with buyers
- How to review the Indication of Interest (IOI), Letter of Intent (LOI), and Purchase Agreement (PA) documents

This white paper is for CEOs, business owners and entrepreneurs looking for simple, practical education on how to sell their company. We encourage M&A bankers, M&A lawyers, wealth managers, and CPAs to share the paper with their clients to ensure entrepreneurs understand the complexities of the M&A process and how important it is to have professional help and advice.

Feel free to send us any comments or questions at research@axialmarket.com.

> The Investment Banking Engagement Letter

Choosing the right investment banker when selling your business is one of the most important decisions you'll make to ensure a successful sale process.

The engagement letter is the agreement between you and the investment banker which outlines the terms and scope of the advisory services provided. It includes the economic points that go to the heart of the relationship. If negotiated and structured properly, the agreement should align your interests and properly incentivize the investment banker to close a deal. To successfully negotiate this letter, it is crucial that business owners understand the interests and position of the investment banker in order to establish a cooperative approach in structuring the engagement letter.

Here are six key points to cover when structuring your engagement letter:

"Fee Arrangement"

Typically, investment bankers will charge a non-refundable deposit or retainer plus a success fee based on closing the transaction. A reasonable monthly retainer is perfectly acceptable from a trusted investment banker, but the retainer should never be paid up-front in its entirety. The investment banker should be putting a significant amount of work into preparing your company for sale and should be compensated for his/her efforts as the work gets completed. Paying a mutually agreed-upon retainer also shows your level of commitment to the sale process. However, in order to ensure your interests are aligned, the success fee should be the most significant component of total compensation.

In addition, the deposit or retainer should be fully credited towards the success fee and the success fee may often include a progressive pricing schedule. In other words, above a certain agreed-upon sale price, the success fee will rise incrementally as the price increases. A progressive schedule is an effective way to provide a strong incentive for the investment banker to help you realize a valuation that exceeds your goals.

"Exclusivity"

Giving exclusivity to an investment banker can feel like a daunting proposition. As the business owner, if you give exclusivity and the investment banker does not meet expectations, it is a tremendous setback. Not only are the time and financial resources you put into the process gone, but now reaching your goal of a sale has been delayed significantly. Additionally, when or if you go back to the market

with a new investment banker, the fact you were already out in the market and could not get a deal done could negatively impact potential buyers' views of your company.

On the other hand, nearly all qualified investment bankers will require exclusivity. From their perspective, they are going to be putting in a significant amount of work preparing your team and your offering materials to go to market. The sale process will take a number of months and can result in many different outcomes. As we just discussed, the deposit/retainer should be a small portion of overall compensation and will not be near enough to pay for the time a good investment banker will spend. How much of their time and energy are they willing to risk if they are not exclusive? Trusted and professional investment bankers take each engagement seriously and dedicate themselves to closing a successful transaction. Finally, M&A processes usually run better with one lead person/firm handling all buyer communication and negotiation. If you are familiar with the phrase "too many cooks in the kitchen spoil the soup," this applies to a sale process.

In the end, it will be your decision whether you give exclusivity to an investment banker. It is a difficult decision and if you ultimately chose not to give exclusivity, be aware this may limit your ability to get a top investment banker in your corner.

"Term of Engagement"

The term of engagement specifies how long the agreement lasts. A six to a 12-month term is reasonable, allowing time for your investment banker to prepare a confidential information memorandum, send out summaries to potential buyers, solicit interest, receive offers, and negotiate a deal.

"Termination and Tail Period"

The engagement letter should explicitly state a right of termination after the term of engagement. Generally, the agreement will automatically renew on a monthly basis until canceled in writing by either you or the investment banker. Additionally, it will include a "tail period"—a period of time after termination during which, if a transaction is completed, the investment banker will still be paid. Typically, the tail period will be two years, although you would like to push for the shortest tail period possible.

The investment banker may try to include the rights to a fee regardless of whether the ultimate buyer was introduced by them or not. If a buyer emerges two years later based on your efforts or the efforts of another investment banker, it is unreasonable to pay the original investment banker who had nothing to do with introducing that buyer. On the other hand, it is reasonable to pay the banker, subject to some time constraint, should the ultimate buyer be someone who was connected by the original investment banker. There can be different definitions of

"connected," but at a minimum, you should restrict the buyers who would trigger payment during the tail period to those who received information from the investment banker, expressed interest, and signed a confidentiality agreement.

"Reimbursable Expenses"

An investment banker will incur reimbursable out-of-pocket expenses such as travel, research, and material preparation during the sale process. You must make sure the engagement letter allows you the ability to exercise some control over these expenses. The investment banker should provide a monthly report regarding expenses incurred. Additionally, the engagement letter should require the investment banker to obtain prior written approval for individual expenses above a certain threshold as well as once an agreed-upon aggregate total expense threshold has been reached. The agreement should explicitly state that violations of these provisions will result in the expenses not being reimbursable.

"Covered Transactions"

A sale process can result in a wide range of outcomes, from selling only a portion of the company for a minority equity position to raising mezzanine capital to the launching of a strategic partnership or joint venture. In order to ensure that certain transactions are not unintentionally included or subject to inappropriate fee structures, it is important that the scope of services provided and transactions covered are well-defined. For example, while the raising of mezzanine capital may be a great outcome for you, the fees due to an investment banker for raising mezzanine capital are usually significantly lower than raising equity capital. In the end, negotiating the "covered transactions" is going to be unique to your specific situation. You want to make sure you are balancing having a well-defined scope of engagement while at the same time maximizing the services of the investment banker to explore all possible outcomes that will satisfy your goals.

Always have a good attorney review the engagement letter as it is a binding legal document with many ramifications.

> Six Keys to Writing Great Investment Teasers When Raising Capital

Now that you've engaged with an M&A advisor, the first document that prospective buyers will review is called an "Investment Teaser" or, even simpler, a "Teaser." While the other materials you prepare are crucial, our research indicates that the Teaser is the most important document a business owner prepares as part of a transaction process. So much so that we've dedicated two chapters to the Teaser.

The Teaser is the first "filter" that every prospective buyer will review before moving forward. If the Teaser does not attract the right potential buyer(s) and help screen out the irrelevant buyers, the rest of your sale or financing process will be much more laborious, less efficient, and likely less successful.

From our research at AxialMarket, we've discovered that active strategic buyers typically review more than 250 acquisition opportunities each year and buy approximately 1-2% of them. Most private equity firms, because they have a broader and more flexible acquisition criteria than strategic buyers, often review over 500 businesses a year and will often only make investments in up to five of those companies. For business owners and CEOs of private companies who are looking to successfully sell their business or raise growth capital financing, these odds place tremendous emphasis on the quality of the offering materials that you'll prepare for prospective buyers.

Luckily, writing an excellent Teaser is not rocket science, and we'll share with you the six common traits of highly effective teasers.

Think of potential buyers of your business as pilots on a search mission, soaring at high altitudes scanning for interesting businesses to finance or acquire. If they see something interesting from a high altitude, they drop down to lower altitudes to take a more careful look. A Teaser provides a 50,000-foot view of your company and gives preliminary access to information they would see if they were to go down to a 5,000-foot altitude. The goal of the Teaser is NOT to sell your company, that will come later; the goal of the Teaser is to ensure the right pilot(s) spot your company and fly down to the lower altitude.

Here are our six tips for writing highly effective teasers:

1. **After reading your teaser, buyers should have a clear understanding of your company.** In order to do this, the Teaser **must** include the following:
    - How your company generates revenue
    - When your company was founded
    - Sales and revenue mix of products and/or services
    - The various industry categories you sell into
    - How your company distributes its products/services
    - The general backgrounds of your management team
    - Overall financial profile: three years of historical Revenue and EBIT/EBITDA and at least two years of projected Revenue and EBIT/EBITDA
    - Four to seven "Investment Highlights" that discuss the unique strengths of your company (i.e. market share leader, owns significant intellectual property, three-year historical revenue growth of 20+%, etc)
2. **Clearly state the goals of the proposed transaction**. Are you looking for growth capital, an ownership transition, recapitalization, liquidity event, consolidation of the shareholder base, etc? Are you looking for a hands-on partner to work through important issues or challenges, or are you primarily looking for capital to scale your existing business? Prospective buyers will appreciate your being up front about your goals and your reasoning for wanting to conduct a transaction. This type of behavior builds a foundation of trust between you and any buyer(s) you decide to engage.
3. **Let the hard facts do the talking.** You are a serious company with important goals. You want to attract professional, experienced buyers. Your Teaser must be a professional-looking and professionally-written document. Always use a professional font (either Times New Roman or Arial). Send it as a PDF file. Do not capitalize words (i.e. AUTOMOTIVE AFTERPARTS SUPPLIER), do not use flowery/wordy language, do not use gushing superlatives (i.e. "once-in-a-lifetime business opportunity" or hyped-up adjectives (i.e. "wildly profitable") to describe your business — they hurt your credibility and make you sound like a used-car salesman. Triple check for flawless grammar and error-free spelling.
4. **Tell the truth**. This is vital. The worst way to start a transaction process is by being dishonest, withholding basic information or stretching your actual or projected financial performance. You will never rebuild the lost credibility with potential buyers, and the odds are incredibly high that they will uncover your dishonesty at some point during the due diligence process.
5. **Keep it concise and professional.** The Teaser should be one full page. This forces you to write concisely and focus on the importance of every word in the Teaser. Remember that your audience reviews hundreds of

acquisition opportunities each year. Make your time count. You want them spending time thinking about how interesting your company is, not trying to understand what your company does and who it serves.

6. **NEVER prematurely disclose the name of your company (or other identifying information).** Prospective buyers will review the Teaser prior to executing a confidentiality agreement, so make sure they cannot identify your company based on information contained in the Teaser. There are many reasons to protect your anonymity, but the most important reasons are to preserve your company's freedom of action, avoid having competitors spread false or damaging rumors, and avoid alarming your employees.

To help you compose your Teaser, AxialMarket's Teaser template is available in the Appendix. In addition, we are happy to review any teaser on a 100% confidential basis, and we will respond to as many requests for review as possible.

> The One Critical Element Every Teaser Must Have

When we built AxialMarket's Teaser Builder software, we looked at thousands of teasers and reviewed the most effective teasers in determining their core elements. Effectiveness was measured and validated by Buyer response and engagement.

While there are multiple important elements of an effective investment Teaser, every Teaser MUST in some clear way answer the following question:

What is the source of your company's competitive advantage?

Why is a clear statement of your competitive advantage so important? Because the essence of your company's value is tied to how sustainable its competitive advantage is. Competitive advantage dictates your company's ability to generate, maintain and grow profitable operations over the long term. When investors look at your company, they seek to understand this as well as possible, and it forms the basis for their estimation of your business' valuation.

Competitive advantage can have many sources: customer entrenchment and high switching costs (ex: database software), long-term contracts (ex: equipment service companies, defense and government contractors), brand recognition (ex: certain consumer products), intellectual property, devoted and stable management teams, culture (ex: Southwest Airlines is a great case study in culture as a sustainable competitive advantage), and on and on. Whatever yours is, clarify in the investment teaser what it is that sets you apart and makes it difficult to copy your organization.

Getting this element of your Teaser written in the right way takes some time, but it's essential. All sophisticated buyers of companies will want to understand your firm's competitive advantage.

Here's why:

- If you have financial buyers evaluating your company, they are going to rely on the sustainability of the competitive advantage to generate a return on their investment. The price they are comfortable paying for the business is directly impacted by how protected the firm's stream of revenues and profits appears to be. The more protected, the more the buyer is willing to pay to acquire your company. If you want to achieve a high price multiple for your company, you must demonstrate to buyers that

your company has sustainable growth potential based on competitive advantage.

- If you have strategic buyers evaluating your company, they potentially have many (or sometimes all of) the necessary in-house resources to try to reproduce your company's products and services. Strategic buyers therefore confront the well-publicized "build vs. buy" strategy when evaluating your company. The more powerful your competitive advantage and the more complex it is to attempt to reproduce the key elements of your business, the more buyers will tilt towards buying your company versus attempting to compete with you. Of course, this raises significant additional complexity for you in terms of sharing information with a would-be competitor, a subject that warrants its own article.
- A good example of the "build vs. buy" decision framework used by strategic buyers is Google's attempted acquisition of Groupon, the hyper-growth local e-commerce company. Google has a cash war chest of over $30B on its balance sheet, a horde of exceptional engineers, global sales and marketing reach, etc. Yet they attempted to acquire Groupon, apparently raising their bid multiple times to up to $6B, rather than try to build Groupon internally. Only Google knows why they tried to "buy vs. build," but it reveals that what Groupon has built is not easily or rapidly reproducible. With the acquisition talks failed and concluded, Google appears to be "building," with the release of Google Offers. This is a classic example of the "build vs. buy" lifecycle and very important for business owners to understand when engaging with strategic buyers.

Remember that nearly all of the buyers you will approach look at hundreds (sometimes thousands) of opportunities each year. They have limited time to review each opportunity and are only able to make a certain number of investments or acquisitions each year. No investment teaser will attract every buyer (nor should it), but yours must effectively attract the right set of buyers. A critical way to develop interest in your firm is to state (note: "state," NOT explain) your competitive advantage.

Of course, the structure of an investment teaser *should* vary based on the business stage, current size, and industry in which it operates. While teasers should be constructed "bottom-up" (AxialMarket's Teaser generation tool is used by companies at all stages, from startup to growth equity, M&A, LBO, and turnaround), all effective investment teasers will clearly articulate the core competitive advantage of the company.

IMPORTANT: Just because you state the competitive advantage of the business does not mean you should explain or reveal the details or intricacies of your company's competitive advantage in the Teaser. In fact, we recommend against it. The Teaser is designed to generate curiosity among relevant qualified buyers such that more thorough materials and in-person meetings can be shared and secured. Other materials, including the Confidential Information Memorandum,

as well as venues (management meeting) will serve as a better forum in which to further explain your company's operations and competitive advantage, so we suggest holding off in the Teaser on sharing the details of how you developed your competitive advantage.

> Three Key Items to Negotiate in Your NDA

If you've created an effective teaser and have sent it to buyers, you will begin to draw inquiries from interested buyers. While it's aspirational to only do business with people in which their word or handshake is adequate assurance, when you're working on a merger, acquisition, private financing, or other meaningful corporate transaction, you must ensure that you get everything important in writing.

Over the course of a private M&A transaction, there will be numerous documents produced and executed, but the one that typically starts the process is a Non-Disclosure Agreement (NDA), also known as a Confidentiality Agreement (CA). If you're selling your business, the NDA is designed to enforce confidentiality among buyers, as well as define terms of engagement, limit what can be disclosed to third parties, and dictate other terms to which counter-parties must agree.

Why Use an NDA?

NDAs are legal documents, designed to protect confidential information from being disclosed to a third party, or being negatively used against the party disclosing the information—often a private business. Therefore, having an NDA in place makes good business sense. As a business owner or CEO considering the sale of your business, you will need to consider how and when to use an NDA to protect your company. Perhaps a private equity group has recently approached you to discuss the possibility of selling your company, even though your business is not for sale at the present time. Or perhaps a competitor at a trade show spoke to you about forming a joint venture. It's important that when these situations emerge you have a basic understanding of NDAs, their key elements, and how to use them to protect yourself and your business. Of course, you should always seek the advice of professional counsel when writing or structuring an NDA. This chapter only scratches the surface.

One-Way vs. Mutual NDAs

NDAs can typically be structured in two formats: a one-way NDA or a mutual NDA. In a one-way NDA, also known as a unilateral NDA, the receiving party of the confidential information is bound to protect such information. For example, if you have been approached by a private equity group, you could require them to sign a one-way NDA; doing so would protect any confidential information you disclose to the private equity group, but you would not be bound if the private equity group disclosed confidential information to you. You can think of a one-

way NDA as protecting your information, but not the information of the other party. By contrast, if a competitor approached you at a trade show, they may insist that you sign a mutual NDA. In this case, any confidential information that you disclose, and any confidential information that the competitor discloses, is protected by the NDA.

Define Confidential Information

The above paragraph mentions several times the phrase “confidential information.” You may ask yourself: “what constitutes confidential information?” It’s an excellent question and the answer is different in many cases, as defined by the NDA in force. But in general, a proper NDA should clearly define what is considered ‘confidential information,’ and furthermore, what is NOT considered ‘confidential information.’ Never sign an NDA that does not specifically indicate what is considered ‘confidential information,’ as you don’t want the courts to interpret the definition for you. Usually an NDA defines that any information relating to products, services, markets, customers, research, software, developments, inventions, designs, drawings, financials, and other items, is to be kept confidential. Exclusions to confidential information may include information already in possession of the receiving party or information that is in the public domain and can be proven to be public. If you plan to use an NDA that does not contain exclusions of what is not confidential, don’t be surprised if the counter-party sends you a revised or marked-up NDA including it.

Define The Term of The NDA

Another key element to negotiate in an NDA is the ‘Term’ of the agreement. You can think of the term as how long the confidential information will be protected. If you, as a business owner, are using an NDA without a term, you should expect the other party to insert a term in the agreement, often one to three years in length, depending on the nature of the transaction and market conditions. This is often where a disconnect occurs between buyers of companies and business owners. A business owner desires to protect his or her information as long as possible. A buyer, on the other hand, will not want to be bound by an NDA for an indefinite amount of time as it creates an ongoing obligation with no end. Think of it this way: would you sign a contract that restricted your actions forever? Not a chance. Don’t expect the same from a potential buyer of your business. Now, as a compromise, a business owner may decide that a five-year term is appropriate. Unfortunately, the majority of buyers will not agree to a five-year term. At most, a buyer may be willing to sign a three-year term, but don’t be surprised if three years isn’t doable with some parties.

There are other important elements which are common in NDAs, which include, but are not limited to:

- **Purpose of disclosing confidential information**: States the specific purpose for which confidential information has been disclosed
- **Returning or destroying confidential information**: Defines how information is to be returned or destroyed and under what circumstances
- **Use of confidential information**: Clarifies that information is not to be used for any purpose other than what was set forth explicitly in the agreement
- **Enforceability of entire agreement**: If one section of the agreement were to be found void, the remainder of the agreement survives and is enforceable
- **Ownership of confidential information**: States which party owns the confidential information

> The Book: Materials You'll Need to Sell Your Company

The purpose of the Investment Teaser, or Teaser, is to state your firm's competitive advantage, not explain it. The Book goes one step further and begins to explain the intricacies of your company. It also provides you with a platform to convince a potential buyer of the value your company will deliver them for years to come.

Many successful businesses spend tens or hundreds of thousands of dollars each year developing marketing collateral and programs to promote and summarize the products and services they offer, **yet they completely skimp on building professional and comprehensive marketing material when it comes time to market their company to buyers**. Sadly, this is some of the most "pennywise and pound-foolish" thinking that we've observed from business owners.

Despite most business owners fully realizing the importance of investing hundreds of thousands of dollars annually in high-quality marketing materials to sell their companies' products, **many fail to appreciate the importance of having professionally prepared materials when it's time to explore an M&A transactions to sell their businesses**. Having a robust set of investment marketing materials will have a substantial impact on the success of the M&A process in three primary areas:

1. The speed of the process
2. The efficiency of the process
3. Overall buyer perception (which contributes to their valuation considerations)

Speed: The more questions you answer in your marketing material, the fewer questions you must answer piecemeal to get the buyers familiar with the business, its dynamics, position, etc. The longer your business is on the market, the easier it is to lose momentum. Speed matters; don't waste time.

Efficiency: The more information you provide to buyers, the more quickly they can "self-select" to determine their true level of interest in the opportunity. No business owner wants to waste time educating a potential buyer on their business only for the buyer to indicate they weren't interested. So the sooner you can help some of them screen themselves out, the better. Use the marketing material to help you decide which buyers to spend time with; ignore the tire-kickers.

Overall buyer perception: Let's face it. Human beings are heavily influenced by the appearance of things. If you go to a trade show and there are lots of service providers there, the booth with outstanding marketing brochures and demo stations will always outperform the booth with the better product that is poorly marketed.

TAKEAWAY: Invest in presenting your business as professionally and attractively as possible. The ROI is substantial.

What Type of Marketing Material is Needed for an M&A Transaction?

For the remainder of this chapter, we'll refer to investment-related marketing materials as confidential information memoranda, or "The CIM." The CIM is also referred to as the "offering memorandum," or, in more informal industry parlance, the "pitch book," or simply, the "book."

Let's say a buyer approaches you to purchase your business and they have already signed your NDA. What should you do next? In an ideal situation you should have a prepared CIM to share with a prospective buyer. The purpose of the CIM is to help a buyer understand your business and the unique strategic investment opportunity it presents.

Well-prepared CIMs tend to have the following:

- Executive Summary
- Company History
- Sales Process and/or Manufacturing Capabilities
- Management Team Structure
- Growth Opportunities
- Competitive Landscape or Industry Outlook
- Intellectual Property Overview and/or Company Assets
- High-Level Financials (preferably five years of historical data and projections, if available)

Each CIM is structured differently according to the company's characteristics. In general, however, it should provide the above information. By providing this information up-front, any discussions with a buyer are streamlined and your deal will progress more efficiently. Here's an example:

Assume you haven't invested in building a CIM and you decide to approach 20 carefully targeted potential buyers to evaluate your company as an M&A target, and ten of them express a preliminary level of interest in your company based on our outreach. Each of them asks you for more information. To answer their questions, you do ten separate conference calls with each buyer and answer some of the exact same questions over and over again. It will take you three conference calls to see what a massive time-suck the process is, especially without a well-prepared pitch book. Instead of running your business while the

buyers digest well-packaged information, you're on the phone and responding to emails one by one all the time. This is a terrible use of your time.

Why Have a CIM?

Once a buyer has reviewed your CIM, they can quickly determine if they want to move to the next stage in the deal process, which typically is a conference call with you. Now, you may ask: if I'm eventually going to do conference calls, why not do it early in the sales process? Well, for one you'll likely only do a handful of conference calls as opposed to a greater number of calls since many buyers will pass on your company after reviewing the CIM. Second, a conference call after a buyer has reviewed your CIM is typically a more in-depth conversation covering topics like your personal goals, valuation and desired deal structure—not basic questions about your company.

Now, the CIM will only take your company so far in an M&A sell-side process. Buyers will always want to speak with you over the phone, visit your company in-person, meet your team and tour your facilities, etc., to get as clear a picture as possible of your business. But a CIM can and should set the tone for all discussions and set expectations in a transaction. Sharing a CIM with qualified buyers is the most productive and efficient way to determine a buyer's level of interest.

Should I have a CIM Even If I'm Not Actively Selling?

You may not even be considering the possibility of selling your business and think you don't need a CIM. However, there are other important benefits to having a CIM you should be aware of. Some business owners find the exercise of assembling a CIM helpful to visualize their business as a buyer would, identify opportunities for improvement, etc. Business owners, by going through the exercise, often uncover issues (perhaps large customer concentration, unscalable processes, or a lack of suitable management expertise in place) in the company that can be corrected before thinking about selling the company. It can also serve as a useful tool when approaching commercial banks for a loan. Lastly, a good CIM can be used in emergency situations (your plant burns down, you lose a key manager or owner to illness, major personal financial change of status).

Don't Go It Alone

The benefits of having a professional CIM outweigh the costs associated with having them prepared. Just as you would not put together professional marketing materials for your business without the help of a marketing professional, don't make the mistake of thinking you can prepare a high-quality CIM for your company without some sort of help. Here, you have a couple of options:

1. **Hire a professional investment bank**. Qualified investment banks have experience building this kind of material. That's part of what they do for a living. Ask them for samples so you can get familiar with their work. Just

like a marketing agency, investment banks don't work for free, so expect to be charged.

2. **Hire an M&A consultant**. This is a less obvious solution, but it might be more economic and it might allow you to have a CIM on-hand without having the pressure an investment bank might place on you to sell your company shortly after they produce the CIM for you. Make sure that the consultants have reference-able customers and can show you specific deals they've worked on in prior careers and some of the materials from those assignments. Some of the material will be off-limits, but they should be able to share some of their work, even if they can't let you keep copies
3. **Work with your CFO**. This is risky if your CFO or VP of Finance doesn't have good materials preparation skills, but it's potentially the most economic. Sometimes, you can start here, begin aggregating the key materials, and then hand it over to an outside firm to put it all together. That might save some time.

Again, the point is to make sure you commit resources to doing this, and don't do it on a one-off basis. Buyers will see the sloppy work, will think poorly of your preparation and your business, won't take your intent to sell seriously, and will low-ball you or simply ignore you. If you're serious about selling, either now or many years in the future, invest in materials that present all the hard work that you and your colleagues have put into building your company.

> The Indication of Interest (IOI)

As the M&A process continues to progress down the funnel and the potential buyer pool narrows, some will provide you with an Indication of Interest. The Indication of Interest (IOI) is a written document prepared by the buyer and submitted to the seller for review as part of the acquisition process.

You may have heard the term, "IOI," but you're not quite sure what it means. Maybe you've also heard of a similar, but different term, "LOI" (Letter of Intent), and you're not so clear as to the differences between these documents and their respective purposes during the M&A and transaction process. So, let's demystify all of this.

What's an IOI? An IOI is a non-binding formally prepared letter written by a buyer and addressed to the seller, whose purpose is to express a genuine interest in purchasing a company. Among other things, an IOI should provide guidance regarding approximate target company valuation, and it should also outline the general conditions for getting a deal done. Elements of a typical IOI often include, but are not limited to:

- Approximate price range; can be expressed in a dollar value range (i.e. $10-15 million) or stated as a multiple of EBITDA (i.e. 3-5x EBITDA)
- Buyer's general availability of funds and sources of financing
- Necessary due diligence items and a rough estimate of the due diligence timeline
- Potential proposed elements of the transaction structure (asset vs. equity, leveraged transaction, cash vs. equity, etc.)
- Management retention plan and role of the equity owner(s) post-transaction
- Timeframe to close the transaction

Of course, there are often other items that a buyer includes in an IOI, but in general, you should see some of the above bullet points in one. Think of an IOI as the very first written offer for your company. It's usually based on limited information—the buyer typically hasn't had a chance to visit your company and conduct any serious due diligence—the only extensive amount of information that has been shared is usually the information / offering memorandum. One of the goals of an IOI should be to help weed-out "tire kickers" and ensure that you only invest time and resources with buyers that value your business within your range and that have adequate industry expertise to understand inherent risks and opportunities that the business has. This is particularly important if your company has many buyers expressing interest as it helps determine the most credible ones.

Now, onward to the differences between an IOI and an LOI…

The LOI is a more formal document than the IOI, and outlines a final firm price and deal structure for your company. Instead of offering a general price range, the LOI gives the final bid for the company in absolute dollar terms or as a firm multiple of EBITDA. Importantly, the LOI is also the point at which buyers seek to lock up your company for an exclusive period of time in which the buyer can conduct a full due diligence process before purchasing the company. If you accept and execute the LOI, it also prohibits you as the seller from speaking with other buyers, whereas, an IOI doesn't.

Keep in mind that your company doesn't necessarily need to receive an IOI before receiving an LOI. There are plenty of instances in which a buyer might submit an LOI without having submitted an IOI prior. This is especially true when a buyer is comfortable enough in submitting a firm offer for your business. It may also be the case that you're working with an investment banker who prefers to go straight to the "LOI stage" of the deal process and bypass the IOI stage, which typically follows the signing of NDAs or confidentiality agreements.

The important thing to remember is that there are many ways to getting a deal done. Some deals obtain IOIs where other ones just receive LOIs. The IOI, while non-binding, helps sellers refine their buyer list, compare buyers' terms, and review a summary of the buyer's intent. The IOI though is exactly what it says—an indication of interest—and by no means is it a guarantee that a given buyer will progress through the entire transaction process.

> The Letter of Intent (LOI)

At this stage you have likely held anywhere from one to three (or more) meetings with a prospective buyer. If you are running a structured sale process soliciting multiple buyers, then you have spoken with several suitors and narrowed the prospects to one to four prospective buyers for these more in-depth discussions.

Ideally the prospective buyer(s) and you should both be at a go/no-go decision point on continuing the discussion. If the buyer elects to continue, then expect to receive a Letter of Intent (LOI) outlining the buyer's proposed deal structure and terms. Receipt of an LOI from a potential buyer is a clear signal that they are serious in their intentions; however it is not a given that they are fully committed yet. Some buyers are known for not closing a high percentage of issued LOIs since their strategy is to lock-up as many potential deals as possible and close only the top three to four of the lot.

The Letter of Intent should include a summary description of all of the material deal terms that will later appear in the Purchase Agreement. There are differing schools of thought on how detailed an LOI should be so your LOI may be anywhere from two to over ten pages long. Those advocating for a shorter LOI argue that using a short form speeds the negotiating process since the parties are focusing their efforts on the primary terms of price, consideration and timing. If there is no agreement on these then there is no need to have covered the other deal terms. Those advocating a long form prefer to have all issues addressed upfront and not have future surprises that can sink a transaction (e.g. reps and warranties, treatment of unvested options).

The following are the common terms you should expect to see in an LOI. Terms are generally non-binding (a non-binding LOI is typical) but a few will be binding beyond the term of the LOI. These surviving terms are noted below.

1. **Deal Structure**. Defines the transaction as a stock or asset purchase. Generally the seller prefers a stock transaction from a tax and future legal liability perspective. Asset transaction is preferred by the buyer to protect against prior liabilities and provides a stepped-up tax basis.

2. **Consideration**. Outlines the form(s) of payment to include cash, stock, seller notes, earn-outs, rollover equity, and contingent pricing.

3. **Closing Date**. The projected date for completing the transaction. It is common for this date to extend past the closing date unless there have been no surprises in due diligence or the Purchase Agreement.

4. **Closing Conditions**. Lists the tasks, approvals and consents that must be obtained prior to or on the Closing Date to close the transaction.

5. **Exclusivity Period (Binding)**. It is common practice for a buyer to request an exclusive negotiating period. This is to ensure the seller is not shopping their deal to a higher bidder while appearing to negotiate in good faith. Expect to see requested periods of 30 to 120 days. Expect the period to be negotiable but the exclusivity term to be non-negotiable.

6. **Break-up Fee (Binding)**. Relatively common to have a break-up fee of approximately 3% or a fixed amount in larger deals (>$500MM est.) but uncommon in the lower middle market.

7. **Management Compensation**. Describes who in senior management will be provided employment, equity plans and employment agreement. This term often vaguely worded to provide the buyer with latitude since they may not be prepared to make commitments to senior management.

8. **Due Diligence**. Describes due diligence requirements of buyer from seller.

9. **Confidentiality (Binding)**. Although both parties have probably signed a confidentiality agreement, this ensures all discussions regarding the transaction are confidential.

10. **Approvals**. Lists any approvals needed by the buyer (e.g. board of directors) or seller (e.g. regulatory agencies, customers) to complete the transaction.

11. **Escrow**. Provides the summary terms of the buyer's expected escrow terms for holding back some percentage of the purchase price to cover future payments for past liabilities. Highly negotiable and often excluded from the LOI and presented for the first time in the Purchase Agreement.

12. **Representations and Warranties**. Will include indemnifications in the Purchase Agreement so best practice to include any terms that may be contentious or non-standard.

The following are less common terms but of no less importance to either party if applicable to the transaction.

1. **Employment Agreements**. This relates to Management Compensation above but may also include favored or long-time employees of the seller. Requiring the buyer to provide employees with employment agreements, maintain current compensation structure, etc. may fall outside their standard post-deal integration practices, and they may simply refuse or require the seller to compensate them.

2. **Retention Bonuses and One-Time Payments**. Similar to above, while sellers may want to "share the wealth" from selling their closely held company, buyers may not want the additional administrative or financial responsibility.

3. **Option Pools**. Treatment of unvested options, vested but underwater options, etc. are not standardized practices. Buyers may opt to honor current option plans by converting them into their plan or similar structure.

4. **Fees**. Generally the party who incurred the charges pays fees, but there are circumstances where ambiguity is possible. For example, if the buyer requires reviewed or audited financial statements from the seller and the deal does not close, then the seller may want the buyer to pay the audit fee.

While the LOI is not binding and the transaction terms, if completed, will be memorialized in the Purchase Agreement, it is a best practice to include all terms that are your deal-breakers in the LOI. Inserting terms into the Purchase Agreement that were not included in the signed LOI is not uncommon, but expect the other side to extract a cost for that change. For example, if you have employees who do not hold equity but you want them to receive a payment at closing or an extended employment contract, that should be in the signed LOI. Secondly, if you have issues that may impact valuation or a buyer's decision to close the transaction (e.g. unresolved equity disputes, regulatory, litigation), it is best that these issues are disclosed prior to signing the LOI. Expect all such issues to be exposed in due diligence and better to have them addressed in the LOI, or dismissed as non-issues by the buyer, than during due diligence when you have incurred legal costs and agreed to an exclusivity period.

The LOI is an important milestone towards a successful sale of your company. If you have not engaged an M&A attorney yet, then now is the right time to add him/her to your deal team. Likewise an opportune moment to consult with your tax accountant and wealth manager for their input on optimal deal structure relative to your personal needs and to engage a seasoned investment banking firm to ensure you are receiving the best deal.

> The Purchase Agreement

Once you have signed the LOI, typically the next major legal document for you to navigate is the Purchase Agreement. This document incorporates all the terms agreed to in the LOI, adds terms and conditions not generally included in the LOI (e.g. indemnification provisions) and will be the reference point used in any post-transaction questions or issues.

You should be leaning heavily on your attorney for help interpreting, navigating, and understanding the details of this document, but ultimately you as the seller are bound by the Purchase Agreement's terms, so you must not "delegate" this one out. You need to be actively involved in the process of taking the first draft and turning into the final draft. This will involve a lot of time, some education from your M&A advisor and your M&A attorney, but it's crucial to a successful outcome.

The following sections and the issues they address represent most of the common material terms found in most Purchase Agreements. Since each transaction is unique, yours may include other provisions that are no less important than those outlined here. The sections are ordered as they are generally found, but it varies by legal counsel and the other authors of the agreement.

Definitions

This may be the most important section of the Purchase Agreement, but it often receives too little attention from the seller because it appears to be basic, standard boilerplate. Every term or word found in the Purchase Agreement that is capitalized (e.g. Purchase Agreement) is considered a defined term and will be found in the Definitions. Material terms such as "Adjusted EBITDA" and "Net Working Capital" that are especially subject to multiple and highly varied interpretations should be clearly and concisely written. Ideally any person reading the document, who was not involved in the transaction and who may not really understand the underlying business, could read the definition and have no doubt as to its meaning. You should know that poorly written definitions can and will become a major future problem should buyers and sellers disagree on the amount of a post-closing working capital adjustment, earn-out calculation or need for a purchase price adjustment. For example, does "Net Working Capital" include only trade receivables? Does "Adjusted EBITDA" include or exclude "market" adjustments to retained seller's salaries? If you don't nail these issues down here, and your transaction is subject to post-closing adjustments, you can expect some potentially major disagreements.

Economic Terms

This section details the purchase price, payment mechanics, earn-out targets and timing of earn-outs, escrows and purchase price adjustments. Some or all of these may be applicable to your transaction. Preferably they were first introduced and agreed-upon in the LOI but it is not uncommon for one or more to appear post-LOI.

Purchase price is often a combination of cash, buyer's stock, or seller financing but could include other items. If the buyer is a public company, then it is here where the mechanics of how the buyer's stock will be valued is found (e.g. average closing price on NYSE for the 10 days prior to the closing date).

Three sources of negotiating friction found here are earn-out targets, escrows and purchase price adjustments. If earn-out targets were not included in the LOI, and it is not unusual for an earn-out to be a post-LOI addition if due diligence has surfaced concerns for the buyer, then discussions over how to calculate the target, calculate the future result (e.g. seller no longer controls company and hence expenses thus what is in or out of EBITDA), and the amount of the earn-out can delay closing or halt the process altogether. Escrows are requested by buyers to cover potential future claims against the seller post-closing. Escrow conflicts are generally over the amount (standard is to express as a percentage of total purchase price) of the escrow period, the frequency of fund releases from escrow (may allow staggered release), and definitions related to materiality of claims and types of claims. The latter is negotiated within the indemnification provisions of the Purchase Agreement. Purchase price adjustments may be tied to agreed net working capital delivered at closing, meeting future financial goals (EBITDA did not decline more than 5% in first twelve months post-closing) or other benchmarks.

Again, the common thread throughout these preceding issues is the need for well-authored definitions.

Representations, Warranties, and Schedules

Sellers and buyers ask each other to state that certain conditions and facts are true at the time of sale; however, the seller's disclosures to the buyer far exceed those made to the seller by the buyer. It is in this section of the Purchase Agreement, and the following on indemnification that seller's will rely heavily on their counsel to protect their interests as most sellers will not be familiar with the terminology. These sections are also intertwined (i.e. a change in one section may only be palatable if a relating term is changed in the other).

There are at least three material issues your attorney will be negotiating for you: who will make the representations on behalf of the seller, for what period(s), and definitions of "materiality" and "knowledge." For example, buyers will often name the "whom" as the company, C-level executives, and material shareholders.

Sellers should try to cut this back as much as possible as this language opens individuals in management or shareholders to personal liability post-closing. As might be expected there are few non-management shareholders willing to accept that risk. Arguably, your counsel and your intermediary is also helping you reduce the number of required disclosure schedules and level of detail provided on them.

While any section may require that a supporting schedule be attached to the agreement, it is the representations and warranties sections that generally require the majority of the supporting disclosure schedules. Generally a Purchase Agreement will include a “Schedules” list or table of one to two pages. To the uninitiated this appears to be a rather benign request. For the seasoned veteran, this is the source of hours of tedious research and dozens, if not more, spreadsheets and volumes of materials to place into due diligence to support the schedules - another source of negotiating friction as each side discusses materiality of data requested and oftentimes for the seller many more thousands in legal fees.

For many sellers who have been through the process, the demands placed on them from this process alone made them vow to never sell another business without third-party help.

Indemnifications

Indemnifications define what actions of one party or events caused by that party damage the other and are heavily weighted towards protecting the buyer. Generally speaking the buyer is trying to protect against future liabilities resulting from sellers’ actions pre-closing and is contractually requiring the seller to agree to compensate the buyer for damages. Friction points in negotiating indemnifications are found in the breadth of actions covered, who must provide the indemnification, how long the indemnification period lasts, caps on damages, relationship to escrow and materiality of claims. Examples of indemnified actions include intellectual property, taxes, employment matters, and securities issues. Buyers and sellers may negotiate a discrete indemnification period and damages cap for each of these items (though some areas such as tax are almost always uncapped). Buyers may ask that management and material, or even all shareholders are held accountable for paying indemnified damages. Sellers will generally work to limit who is making the indemnification, ask for a cap on damages of no more than the escrow amount and limit the indemnification period to no more than the escrow period. Lastly, indemnified items may be subject to a deductible and to a materiality standard. In other words, a basket is created where the first $xxx of claims is held and if the basket amount is never exceeded the buyer pays the claims. Disagreements over indemnification provisions can and have scuttled transactions so best to address this section early on in reviewing the first draft.

Interim and Post-Closing Covenants

Interim and post-closing covenants detail how the seller and buyer promise to conduct business before and after the transaction. One surprise many sellers face upon reading the first draft of the Purchase Agreement is the number and specificity of the interim covenants. Standard requirements include not hiring any new employees, not granting any bonuses or salary increases, and no purchases greater than $10,000. Effectively the buyer has valued the seller's business based on the operations and numbers as-of the LOI date, or earlier, and expects to receive a business very little changed from that decision date. Post-closing covenants may include non-competes, providing transition services, and seller's providing ongoing D&O insurance for former management and directors. Non-competes are highly negotiated and may vary greatly between individual sellers. Non-competes are also highly variable in allowable terms depending on the seller's state of residence.

Closing Conditions

The simplest description of closing conditions is a list of items to be delivered or events to have occurred before each party exchanges signatures on all of the deal documents. It sounds so simple. Closing conditions may include regulatory approvals (e.g. business requires government-issued licenses or permits which are often non-transferrable or require long lead times to transfer), written consents from all seller landlords (even for stock sales), written consents from customers and vendors where the seller's agreement with them did not include a change-in-control provision or still requires written consent, etc. The seller's attorneys and intermediary generally are coordinating activities needed to meet closing conditions by the targeted closing date. It is possible to close without satisfying all conditions but at the complying parties discretion and expect that to cost something.

The above is just a snapshot of the pitfalls, issues and key terms that make up the Purchase Agreement with a few examples to highlight why this is such an important document and must be drafted and negotiated rigorously. Each of these sections could be a multi-page article in its own right and the risks, complexity, and time-intensive nature of getting this work done properly further points to the importance of having an experienced supporting deal team of attorneys and M&A advisors in place when selling your business.

We'd also like to thank Eric King, Managing Director at Viant Capital, who contributed to this paper. Viant Capital is a provider of transaction advisory services to lower middle market companies. Eric has led or participated in transactions totaling $12 billion and has served as a turnaround CEO and start-up co-founder/CFO.

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> Appendix

Opportunity Headline

Financial Information

	2009	2010	2011E
Revenue	$10,000,000	$12,000,000	$15,000,000
Y-o-Y Growth	-	*20%*	*25%*
Gross Profit	-	-	-
Gross Profit Margin	-	-	-
EBITDA	$1,000,000	$1,500,000	$2,000,000
EBITDA Margin	*10%*	*12%*	*13%*
CAPEX	-	-	-
CAPEX / EBITDA	-	-	-

Company Overview

Organization Type: **S-Corp**

Headquarters Location: **US - East South Central (South)**

Description:

Seller Contact

Dan Lee

email dan.lee@axialmarket.com

company phone 800-860-4519

website http://www.axialmarket.com/

Transaction Details

Seller has the exclusive mandate to represent this company.

Preferred Type(s) of Transaction:
Buyout or Acquisition

Acceptable Type(s) of Investment:
Equity

Available Ownership Position:
Controlling

Transaction Fee:
Paid by Seller

Company Details

Industries:
Industrial Machinery

Company Offerings:
Sells Products

Company Assets:
Capital Equipment, **Facilities**, **Intellectual Property**, **Real Estate**

Company Capabilities:
Engineering, **Manufacturing**

Company Sales Channels:
Direct Sales

Customer Sectors:
Corporations/Businesses (general)
Manufacturing

Customer Geographic Location:
US - East North Central (Midwest), **US - East South Central (South)**, **US - West North Central (Midwest)**

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