The Deal Behind the Deals

Pros Offer Stories, Facts and Analysis

By Tom Schuman

When the subject is business deals, there is no shortage of experts to speak to – and no lack of interesting insights. Unfortunately, there was no time to connect with more of the "dealmakers" and not enough room in this publication to share all of the information learned.

At a basic level, those listed below agree on a number of concepts. They include the significant impact of the Great Recession on deal flow, the need to adhere to documented processes to make transactions happen and that caution and due diligence are at higher levels than ever – everyone wants to get the deals correct.

- **Eric Davis**, founder and managing partner of JED/Venture Partners. He has developed a variety of venture-backed businesses based upon technology licensed from major research universities
- **Christopher Day**, managing principal of Navidar, an investment banking firm with average deal sizes between $100 million and $300 million
- **Chris Goeglein**, a principal and founder of True North Strategic Advisors. That followed nearly a decade of leading corporate transactions for Lincoln Financial Group
- **Thomas Hiatt**, founding partner of Centerfield Capital Partners, one of the largest private equity firms based in Indiana
- **Joe Hornett**, senior vice president, treasurer and chief operating officer of the Purdue Research Foundation
- **Steve Johns**, CEO of Confluence Pharmaceuticals, the latest in a series of business ventures. He also has worked 10 years in banking and financial management
- **Jim Macdonald**, senior vice president in the Midwest Region of Commercial Banking for JPMorgan Chase
- **Larry Metzing**, a senior partner at Sunbelt Indiana Business Resource, which operates in the small to mid-market business range
- **Oscar Moralez**, with nearly 20 years of experience in the life sciences industry, co-founder and managing partner of StepStone Business Partners and StepStone Angels
- **Tony Schneider**, a senior vice president with BKD Corporate Finance, which targets transactions greater than $10 million in enterprise value
- **Jeff Smith**, a business buyer advocate for "Partner" On-Call Network, specializing in deals up to $2 million in seller's discretionary earnings

We share more in the next few pages (including terminology in the merger and acquisition world, page 88). The examples shown were narrowed down from a list that began with 143 entries.

‘Fascinating’ Deals

- **Hiatt** discussed several deals in which his company worked with Indiana sponsors and provided some equity and mezzanine capital. One was Coast Composites, a California-based manufacturer of tooling systems to make composite parts for jet engines. “The timing was excellent. We sold to a publicly traded U.K. company. It was a fascinating deal and a great return.”

- **Metzing:** HETSCO was an Indianapolis company that featured a pair of welders who repaired heat exchangers for petrochemical companies around the world. “They were the Red Adair (famous for putting out oil and gas well fires) of their industry. When a heat exchanger goes down, everything goes down. A company could lose a million dollars every few hours. These guys would get a call and be on a plane to South America the next day.” Metzing’s company sold HETSCO to a retired utility executive in 2004. The company has since been sold again.

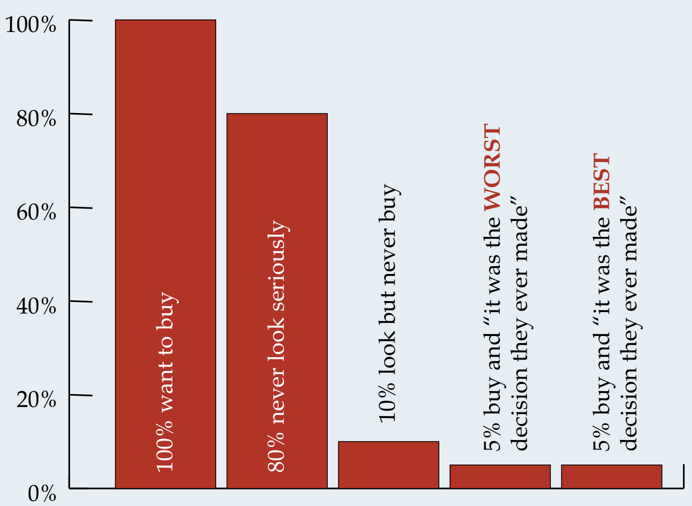
- **Goeglein:** Tragedy struck several weeks before closing a 2006 deal when one of two shareholders, who had worked together for a long time, suddenly passed away. “It created a whole set of issues. It was difficult and rewarding. We had lost a client and a friend. The concern moved to how could we keep the deal together for that person’s family and the other shareholder.”

- **Hornett:** Singles out Endocyte, a Purdue Research Park start-up from the mid-1990s that actually dates to research by a Purdue professor in the late 1980s. It has been through two rounds of clinical trials and launched an initial public offering earlier this year. He describes stock shares launching at a much lower level than expected as the “financial overhang we currently have, the recession that is officially over but seems to be lingering on.” (Shares have since rebounded). As for the company, he adds, “For a start-up company that doesn’t even have product in the marketplace yet, they actually have a pipeline. They’re not a one-trick pony. They’ve made a little splash, and we have every reason to believe a big splash is around the corner.”

- **Anonymous:** “It was not very many dollars, but we were able to buy assets from a large public company. They just had no clue to the value of the assets and what it meant from a strategic asset to us. That was probably the most fun; you know, when you can walk in and play at the poker table and they’re not able to read you.”

Poker playing skills may come in handy in business dealings.

Business Buyers



Source: Jeff Smith reiterating an old saying

Jeff Smith

“When I had my company for 17 years, about eight years in it, I bought a company that was the same size. I went from $4.5 to $8.5 million in revenue, 24 to 48 people overnight. My only regret was I didn’t do it about every two years. There were lots of deals out there I could have taken advantage of to grow my company continually. Buying a business is really the safest, quickest and easiest way to grow your business that you can do.”

Jeff Smith

Numbers Have to Add Up

- **Schneider**, who says he and others in his company will spend 40 to 60 hours with prospective clients before being hired: "It's important for us as much as the client to understand the value of the company. At the end of the day, we get paid for closed deals. If we think it's worth $50 million and the client think's it's worth $70 million, we likely won't take that job. The last thing we want to do is spend several months of our life working on a deal that is not going to close, and we're not going to get paid."

- **Metzing:** "One of the first things we do in the process is an estimated market valuation; that is probably the biggest indicator of whether the seller is going to be motivated. If the seller is unrealistic in his value expectation, we're going to cut the process short pretty quickly. If he thinks his business is worth $5 million and I think it's worth $2 million, we're probably not going to go very far."

Larry Metzing

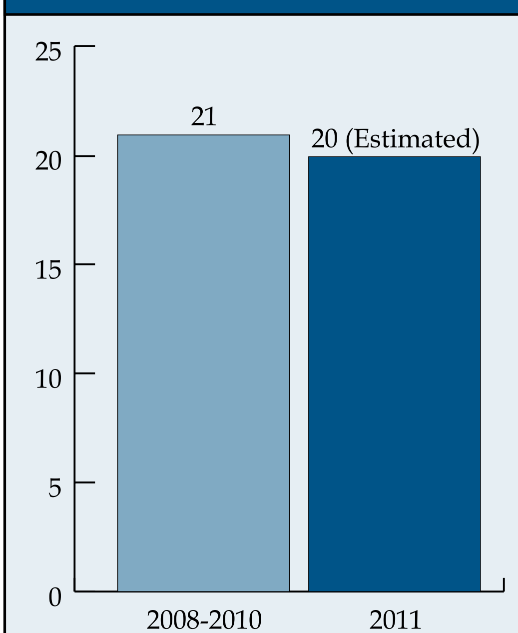
Aging Factor

- **Schneider** says of the last seven potential engagements, the seller was at least 65 years of age in all but one instance.

- **Smith** reports that for companies valued at less than $20 million (in 2007), 85% that had been in business for more than five years were owned by someone over the age of 55. "Before the Great Recession hit, the largest transition of wealth was going to occur." Now, he says, there is a lot of "pent-up demand."

- **Metzing** terms demographics as the driving force in the next 10 to 15 years, noting that after the last few years "sellers are coming out of the woodwork." He adds that most business owners don't plan for succession and that the "number one reason most businesses sell is burnout – not retirement, not any other reason."

Deal Volume
(BKD Corporate Finance)



"It certainly looks like the current year is shaping up to be a 20-deal kind of year. To put that in perspective, in '08, '09 and '10 we did 21 deals, which was actually pretty good. I can guarantee you there were clearly some other investment banking shops, that if they had 21 deals (in those three years), they would probably feel really good about life."

Tony Schneider

Art vs. Science

- **Johns:** "It's a little more art than science at times. You've got to clearly have committed parties with realistic expectations. Momentum is such an important part … so you really have to minimize distraction."

- **Day:** "At the end of the day, relationships are the most critical thing. Investment banking services are an extremely hard thing to buy. What we do is an art, not a science. It's an ever-evolving deal-making environment."

Hidden From the Market

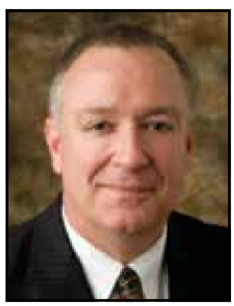
- **Smith** contends that with companies under $25 million in revenue, "80% of the profitable businesses that sell are never listed on the Internet or by a broker." Sellers are worried about confidentiality leaks, and in some cases the commissions they have to pay. "So they sell to somebody that knows somebody that knows somebody."

- **Metzing:** "So many transactions never see the light of day, never make it to the market. They work with the first person who contacts them about buying. Taking that business to market is the only way to determine real market value."

- **Goegelein:** He and his colleagues are all from Northeast Indiana, where they focus much of their business today (along with Northwest Ohio). "We feel like this area has a significant concentration of quality firms. We think there's a lot of hidden gems, quiet companies because they're not in the center of the state and a lot of people don't know about them. It creates a bit of a niche for us."

Great Recession's Lasting Impacts

All agree that, in most cases, it simply takes longer today to get a deal done.

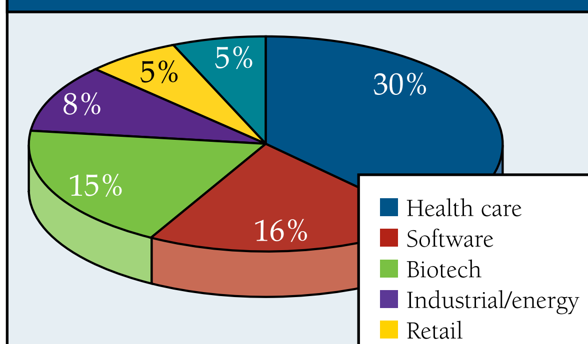


Joe Hornett

- **Hornett:** "Does it take longer? There is absolutely no doubt about that and probably the best example of what the difficulties have been since everything kind of turned down in 2008 is (our research park in) Indianapolis. When we opened our park and incubator facility there, almost in lockstep with when everything turned bad, Indianapolis was a place we thought we would fill that initial facility quite quickly. As recently as November-December 2010, we were still at 25% occupancy. Markets are still constrained, commercial lending is still tight, but things are getting better and it's now evidenced by the fact that we're almost at 100% occupancy now. There is still a chill and a lot of caution that is out there; things are taking longer because both sides of the table are being extremely careful."

- **Macdonald:** "There's been a little bit of a return to discipline on capital structures. There have been certain go-go times, sometimes called the frothy periods, and during those times you've seen things like very high debt multiples tolerated, very high multiples allowed on bank financing. Times, for instance, in the late '90s, when you would see certain banks and finance companies entertaining senior debt multiples of four times cash flow or even greater. I'd say that's very uncommon today. A lot of those deals were deals that got people into trouble. Today, higher amounts of equity are required. I think the equity sponsors understand that so there are a lot of deals where now 50% or 60% equity from the financial investor is required. That's not true of all deals, but it's true of many."

Angel Investing by Sector (2010)



Source: Center for Venture Research

2010 Angel Market

- Angel investments . . . . $20.1 billion
  (14% increase over 2009)
- Active investors 265,400
- Ventures receiving angel funding 61,900
  (8.2% increase over 2009)

Angel Investor Deals

(general statistics provided by Moralez)

- Companies looked at 100
- Companies presented to angels 20
- Investments out of the original 100 3

Indiana's Status

• **Davis** reveals that while Indiana and the Midwest have more than their fair share of great research institutions "providing high-quality intellectual property," available capital doesn't measure up to the San Francisco area, or Boston or New York on the East Coast. "When you have deals that require significant amounts of capital, like therapeutics and some life sciences, you typically need some connection to those capital areas. What I found that is for smaller deals, less than $3 million, we have a pretty robust capital structure and it's getting more formal. Many of the angel networks are getting more formal and sophisticated. Our sweet spot seems to be in the capital raises of between half a million and two million. For a lot of technology companies, for example in software and IT, that may be all the money they need to get to a point where they're profitable."

Eric Davis

• **Hiatt:** "We market our firm nationally and see investment opportunities from a number of different regions. We have a carefully crafted set of investment criteria; it's a continual challenge for us to find great companies that meet our investment objectives. We have invested in a number of Indiana companies. All things considered, if there's a great opportunity in Indiana versus say California, by a factor of three or four, we'd rather invest close to home than farther away."

• **Moralez:** "The trends are risk aversion and risk mitigation. What that means for investors is more of a shift toward decreased risk. A lot of people have seen portfolios shift pretty dramatically. At the same time, there is a shift in mindset – traditional markets do carry significant amount of risk and volatility, so these alternative investment opportunities may be ways that investors can more closely manage at least a portion of their investments in a more local way. For the most part, companies we invest in are Indiana companies."

The Bay Area boasts impressive structures and venture capital, but Indiana has its own advantages.

Don't Forget ...

• **Davis:** "In two recent deals, capital has been available globally, particularly working on a deal with a group in China and also in Europe. I encourage folks, because of this global nature of things, to look for capital and partners outside the U.S."

• **Goeglein**, while with Lincoln Financial Group, worked on the insurance sale of American States to Safeco. "The largest transaction I worked on in my career, but probably the easiest. At the time, Lincoln owned a majority of American States but it had a part of it that was publicly traded. One thing my partners are tired of hearing – the complexity of a deal is inversely proportional to its size. The larger a deal, the more resources you have available; if a company is publicly traded, there are all kinds of disclosures that are required already. It just makes the deal easier."

Chris Goeglein

• **Day**, on his past experience as an entrepreneur: "A lot of companies we're working with here in Indiana, especially, really like that because I've lived in their shoes. I understand what it's like firsthand how to build a business, how to make payroll, how to hire the right people, putting the right rear ends in the right seats to build a cohesive team."

• **Macdonald:** Old-time bankers would say: "At the end of the day, you don't lend money to a company; you lend money to the people who own it and run it. That is a core principle for us. None of that (paper) makes a deal a good deal if you don't have high-quality, high-caliber, high-integrity people involved with the company, particularly the owners and the management team."

• Metzing refers to it as "time kills deals" and **Moralez** expands by saying: "The biggest obstacle, based on my experience, it's the timing and the driving to some sort of closing. Working on the deal terms, being creative, making it a win-win for both the investor and the entrepreneur. There are a lot of ways to structure deals to make them happen. But sometimes the investor gets fatigued with trying to negotiate, or the entrepreneur gets fatigued, and they move on."

Oscar Moralez