Successful Exit Strategies

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Agenda

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M&A Landscape/Deal Structure

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M&A Landscape/Deal Structure

John Keenan

Third Party Sale Alternatives

Presentation Goals

- The purpose of this discussion is to talk about some of the exit strategy best practices we are currently seeing and expect to continue in 2015 in the defense government services markets
- For companies looking to exit within the next 1-2 years, we will discuss some ways to best prepare the company to maximize value and ensure the transaction ultimately closes
- For companies with a longer time horizon, in addition to this discussion we will also talk about some best practices with respect to treasury and employee retention
- We will set the stage for this discussion using the case study on the next slide

Case Study

- Buyer Corp is acquiring Seller Corp in a cash and seller note transaction; the parties are currently in the middle of due diligence
- Buyer Corp is a large, publicly traded entity with several hundred million in revenue
- Seller Corp is a fast growing, privately held S-Corp:
  - $40 million in LTM revenue; $4 million in EBITDA
  - Forecasting 15% annual revenue growth for the next three years
  - High value employees and management team and holds attractive intellectual property (IP)

Transaction Summary	
Estimated Close	February 27, 2015
Structure	IRC § 338(h)(10)
Total Consideration	$50 million
Cash at Close	$30 million
Seller Note	$10 million
Earnout	$5 million over 2 yrs
Escrow	$5 million

- Transaction hurdles:
  - Aggressive growth forecast risk increased by key task order re-compete lost during due diligence and one large award under protest and several others are delayed
  - Several small business set-aside contracts
  - 30% ESOP ownership
  - Key employees must be retained for future success
  - Plaintiff in an ongoing lawsuit

Potential Transaction Hurdles

Missed Projections

- Seller Corp is a fast growing company with an aggressive forecast
- While Seller Corp appears to be on track to achieve 2014 financial projections, the recent loss of a key task order and an on-going protest on recently-won work make 2015 projections appear tenuous
- LPTA pricing on new tasks makes 2015 EBITDA margins appear to be closer to 8% instead of 10% historical average; Buyer Corp not giving Seller Corp credit for EBITDA adjustments due to large portion of revenue from CPFF contracts

Seller Perspective

- There are many very large growth opportunities not adequately captured in a probability-weighted forecast; 2015 has not even begun
- Want credit for delayed revenue – owners already losing value on front end, don't want to be penalized post-sale as well
- EBITDA adjustments are legitimate

Buyer Perspective

- Portion of anticipated revenue and EBITDA will now not be recognized in 2015
- Contract delays raise questions regarding market suitability and growth prospects
- Forecast credibility concerns and increased buyer risk
- Adjustments not valid with cost-reimbursable contracts

Possible Solutions

- Seller Corp accepts a larger earnout component
- Buyer Corp reduces overall valuation but increases cash offering
- Buyer Crop reduces cash at close but replaces cash with Buyer Corp stock that increases the total transaction value

Potential Transaction Hurdles

Small Business Set-Aside

- Seller Corp is transitioning from the small business designation and 80% of its work is full and open
- The other 20% is small business set-aside work not scheduled to expire for another three years
- Seller Corp has a strong customer relationship and does not expect to lose the work in a transaction, but was assigned a new contract officer within the last 12 months

Seller Perspective	Buyer Perspective
• Expects to recognize full value from existing set-aside contracts • The past-performance and customer relationships have value to the buyer • There is a transition plan in place with multiple paths	• 20% of the company's revenue is immediately at risk post acquisition • Set-aside work tends to be very difficult to transition – risk at change of control as well as when recompete comes up

Possible Solutions

- Seller Corp takes on the contract risk in the form of an earnout
- Seller Corp sells the small business contracts or spins off a division as a separate company
- Buyer Corp pays a lower valuation for the set-aside work

Potential Transaction Hurdles

338(h)10 election and possible blown S election

- Seller Corp is being sold by S Corporation shareholder
- Buyer and Seller have agreed to a 338(h)10 election
- During due diligence and in a review of the Company's capitalization, Buyer believes that Seller may have inadvertently issued 2 classes of shares – violating its S-Corp status

Seller Perspective	Buyer Perspective
• Seller does not believe that there is an issue	• Tax benefits of 338(h)10 election factored into deal price • If the transaction does not qualify, this is a material reduction in purchase price

Possible Solutions

- Reduction in purchase price
- Delay transaction until issue is resolved
- Larger portion of proceeds in earnout or escrow

Potential Transaction Hurdles

Employee Retention Pool

- Seller Corp has several key employees associated with the Seller Corp's IP's creation and maintenance
- The management and business development teams maintain critical customer relationships that are crucial to Seller Corp's growth expectations
- During diligence Buyer Corp identifies 10 employees who are "key" to the transaction

Seller Perspective	Buyer Perspective
• Avoid extended contractual obligations post-acquisition • Limit risk and liability costs associated with retaining top-tier talent	• Retain "key" employees for as long as possible to secure growth and eliminate risk • Receive some compensation if "key" employees depart, limiting future growth

Possible Solutions

- The retention pool is seller funded and taken out of purchase price at close
- The retention pool is buyer funded and the cost is added on to the purchase price
- The retention pool is seller funded through a note
- Share the associated costs evenly

Potential Transaction Hurdles

Litigation Liability

- Two years ago a teaming agreement with an industry competitor collapsed and Seller Corp retained a majority of the work
- Former partner company suspected foul play and is suing Seller Corp for $10 million
- Litigation is ongoing with no clear outcome

Seller Perspective

- Avoid retaining liability
- Avoid being penalized for old, failed partner agreement
- Minimize cost and end quickly; however, do no rush into a settlement

Buyer Perspective

- Not responsible for prior ownership mistakes
- Settle the dispute as quickly as possible
- Would like to be fully indemnified by the seller

Possible Solutions

- Seller Corp settles and legal fees and settlement are paid by Seller Corp prior to closing
- Seller Corp agrees to indemnify the Buyer Corp, payables associated with legal fees accrued pre-closing will be included in working capital calculations
- Escrow is increased to account for potential claims

Potential Transaction Hurdles

ESOP Buyout

- Seller Corp sold 30% of its outstanding shares to an ESOP five years ago
- An independent trustee, valuation firm, and attorney have been assigned to represent the ESOP in the transaction
- Buyer Corp, Seller Corp, and the transaction trustee all prefer to shutdown the ESOP at close; however, Seller Corp and the trustee must negotiate a buyout of the escrow, earnout, and note

Seller Perspective

- Reduce future expense by closing ESOP
- There is substantial risk in the earnout, therefore the buyout should be heavily discounted

Buyer Perspective

- Must act in best interest of shareholders
- Given Seller Corp's projections and outstanding IP the earnout should be secure and generous

Possible Solutions

- Negotiate a buyout
- Keep the ESOP open and indemnify the buyer

Potential Transaction Hurdles

Working Capital Requirement

- Middle Corp has a trailing 12-month average non-cash working capital of $5 million
- Two months ago non-cash working capital increased to $8 million due to a series of large invoices to a slow paying customer
- PE Company claims that, given the Company's growth prospects, the recent working capital levels are more indicative of the Company's ongoing working capital needs rather than the trailing 12-month average

Seller Perspective

- Working capital spike is a one-time occurrence
- Target working capital of $5 million accurately represents the future short-term capital needs of the business
- Excess payables are 100% collectable and are due to the current owners of the business

Buyer Perspective

- Given the Company's growth prospects, trailing analysis is not a true reflection of the future working capital needs of the business
- Concern regarding bad debt expense of excess payables
- Wants to avoid paying a large amount at closing for excess working capital

Possible Solutions

- Provide clear terms at the LOI negotiations stating the target amount of working capital required
- Forecast forward monthly balance sheets to show normalized levels of working capital
- Expedite collection on receivables prior to closing to reduce working capital

Summary Takeaways

- Think early and often about how decisions today may impact a potential sale
- It's never too early to take steps to best position a company for sale
- Anticipate problems and establish contingency plans
- Be prepared to share risks and costs
- There are no perfect transactions
- Everything is negotiable

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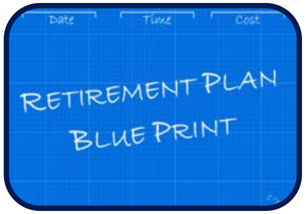
Exit Strategy Alternatives for Government Contractors

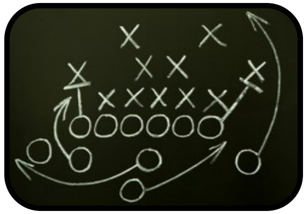


Retirement Planning

Defined Benefit Planning

Sale to Current Executives

Sale to Employees



Business Strategy

Third Party Sale

Menu options

Date | Time | Cost

RETIREMENT PLAN BLUE PRINT

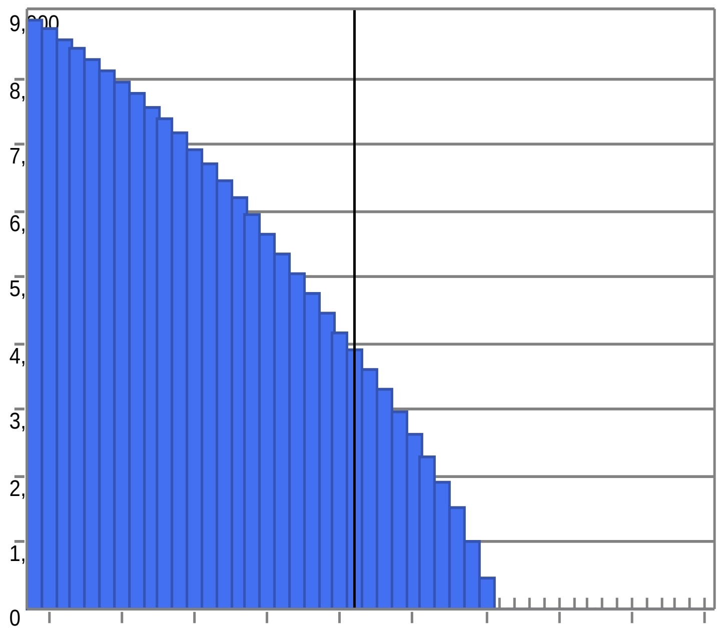
Which owner is more likely to retire comfortably? A or B?

Owner A	**Owner B**
• 45 yrs old	• 65 yrs old
• Annual Income Need: $300k gross	• Annual Income Need: $300k gross
• Business Proceeds: $10M	• Business Proceeds: $2M
• Retires at 45 when business is sold	• Retires at 65 when business is sold
• Takes SSI at 67	• Takes SSI at 67
	• Has pension income

Straight line outcomes: 45 vs 65 yr old

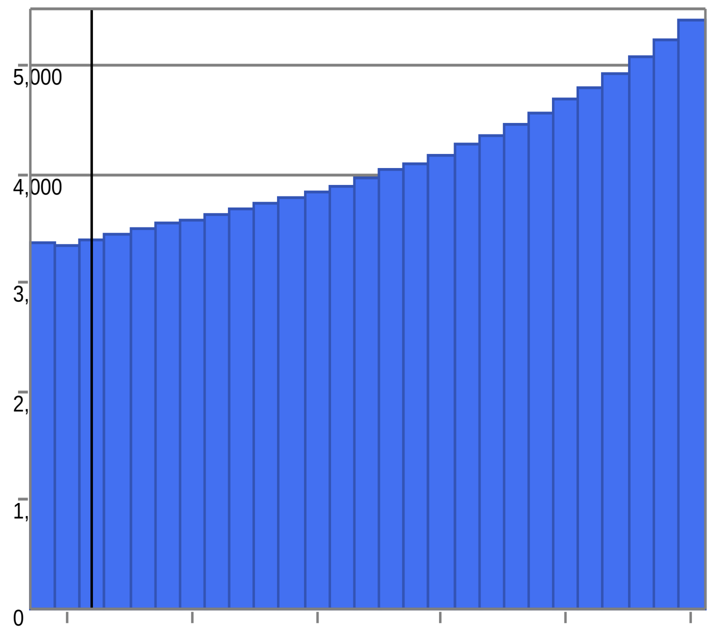
Owner A

Portfolio Assets



Owner B

Portfolio Assets

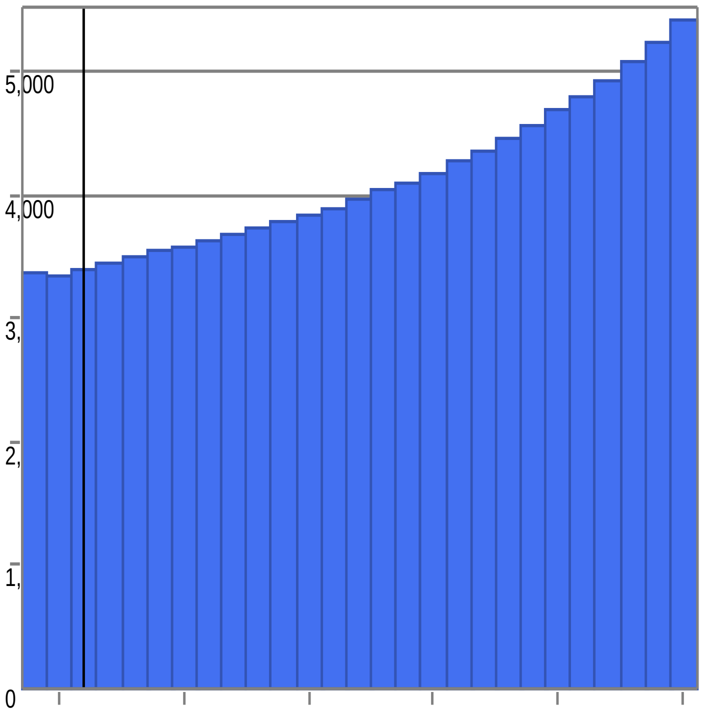


Monte Carlo simulation is 5% successful

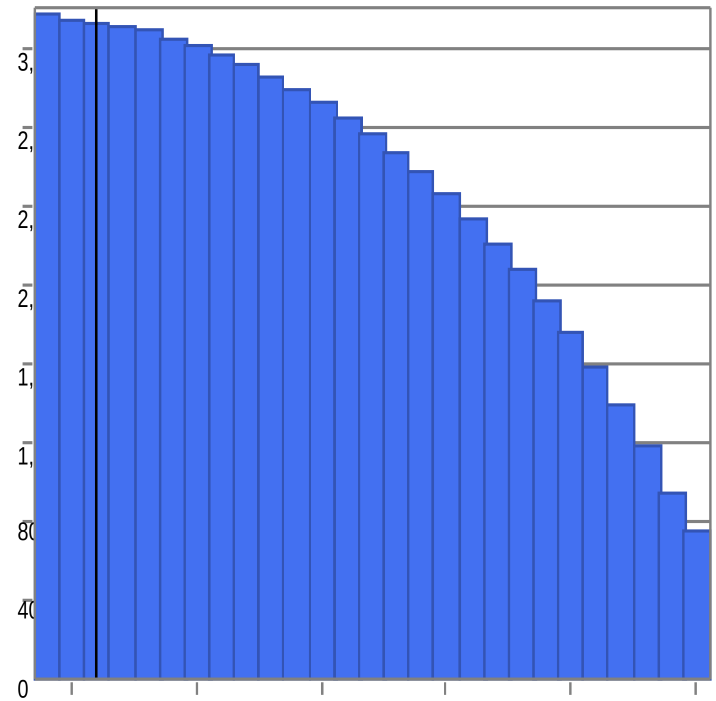
Monte Carlo simulation is 98% successful

Owner B (65) with / without pension

Owner B w/Pension



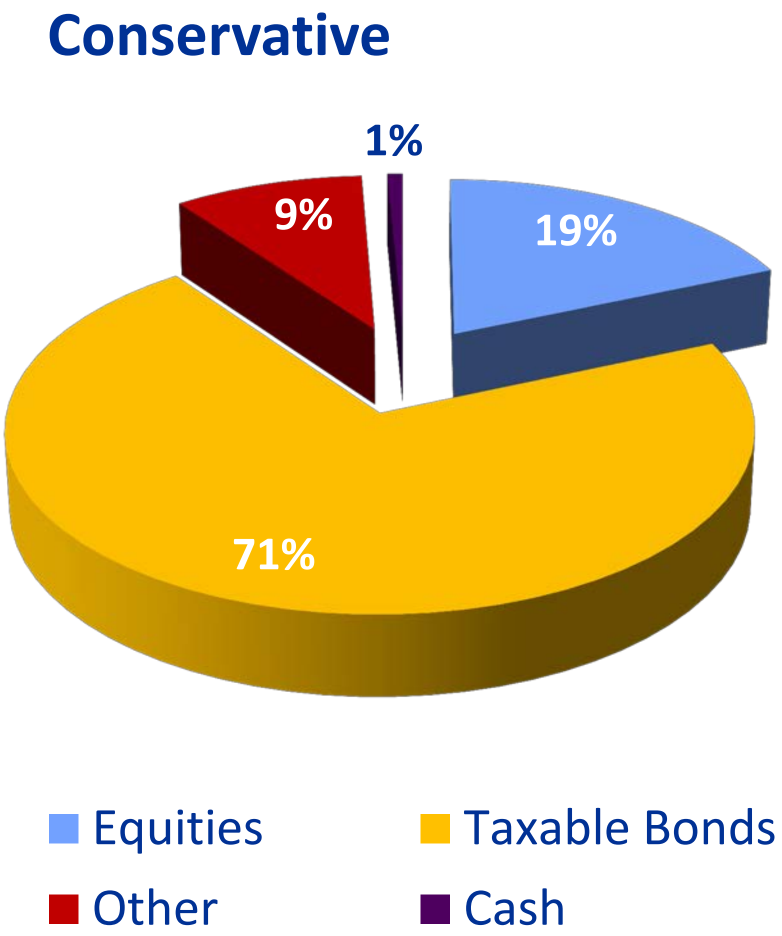
Owner B w/o Pension

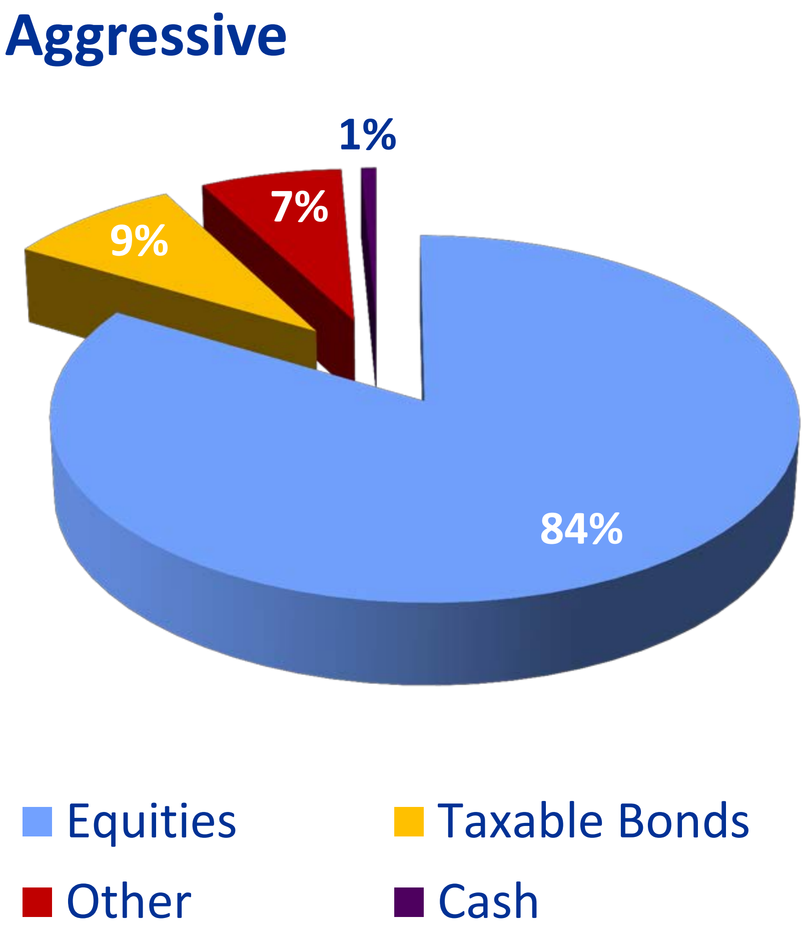


Monte Carlo simulation is 98% successful

Monte Carlo simulation is 42% successful

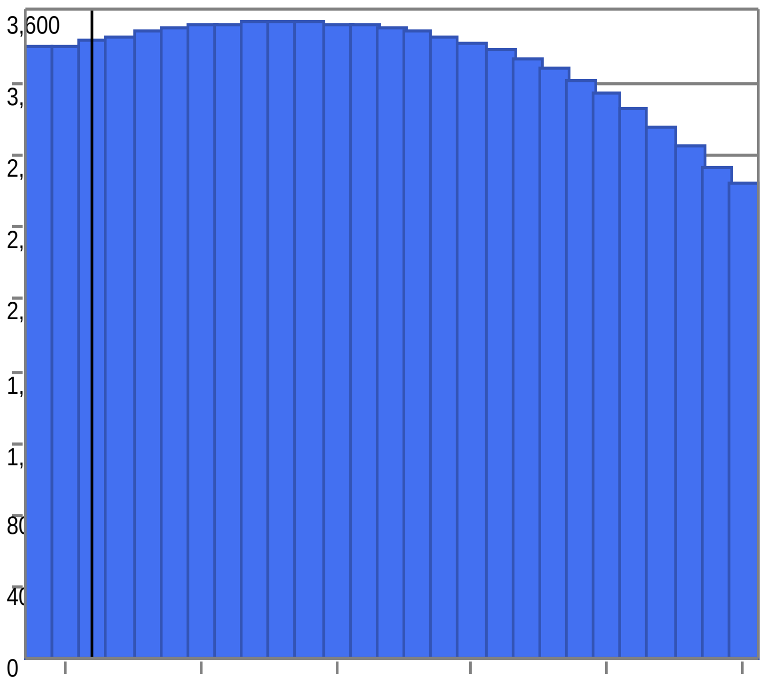
Outcomes using different investment profiles for the same client





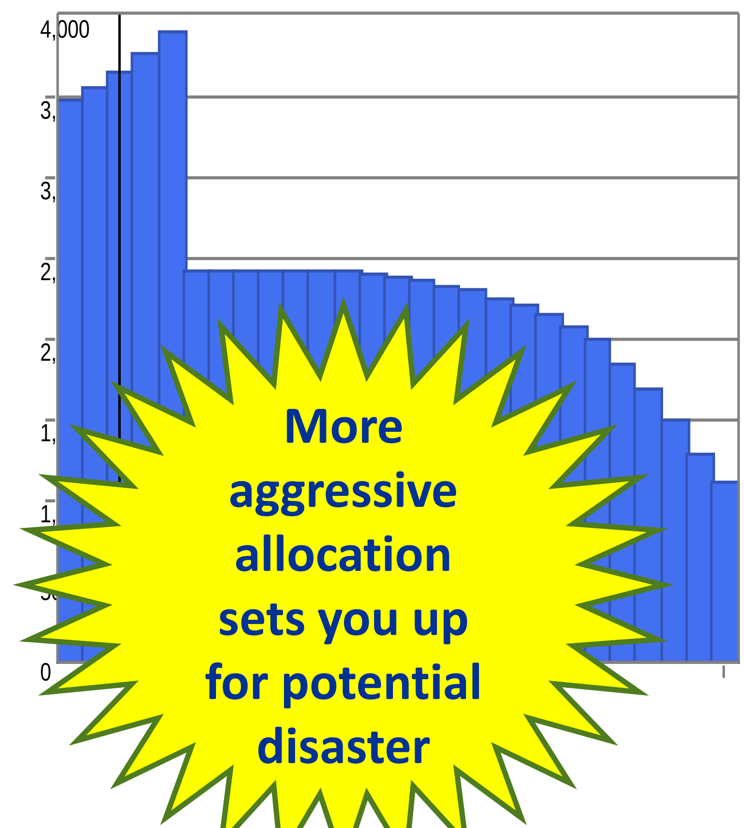
Outcomes based on different allocations

Portfolio Assets Base Facts



Monte Carlo simulation is 79% successful

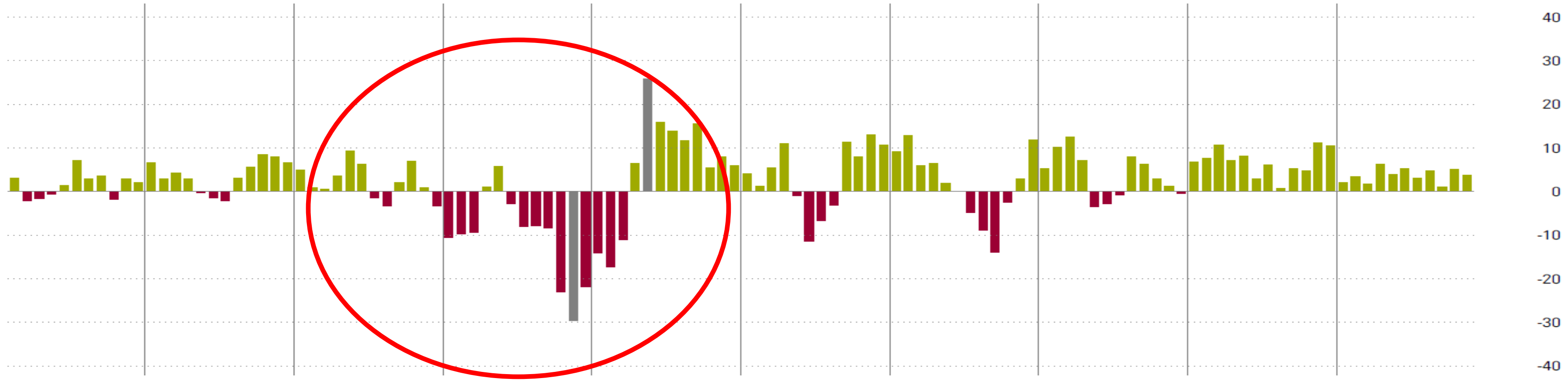
Portfolio Assets Base Facts with Aggressive Allocation



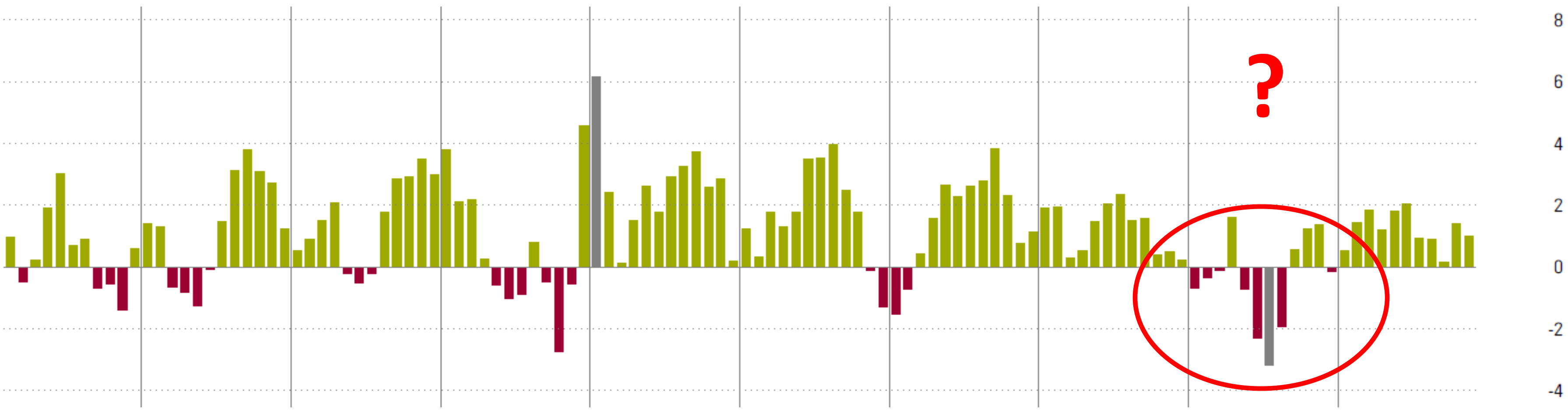
Monte Carlo simulation is 43% successful

Avoiding sharp or prolonged periods

Stock Index Returns: June 2004 - Present



Bond Index Returns: June 2004 - Present



Typical Balance Sheet

Non Qualified Assets

Cash Equivalents

Checking:	$250,000
Savings:	$250,000

Taxable Investments

Trust A	$714,407
Stock Account:	$1,227,376
Muni Bond Acct:	$892,000
Trust B:	$2,598,290
Sub-Total	***$5,882,073***

Retirement Assets

Qualified Retirement

IRA:	$2,201,532
Roth:	$916,191
Sub-Total	***$3,117,796***

Life Insurance

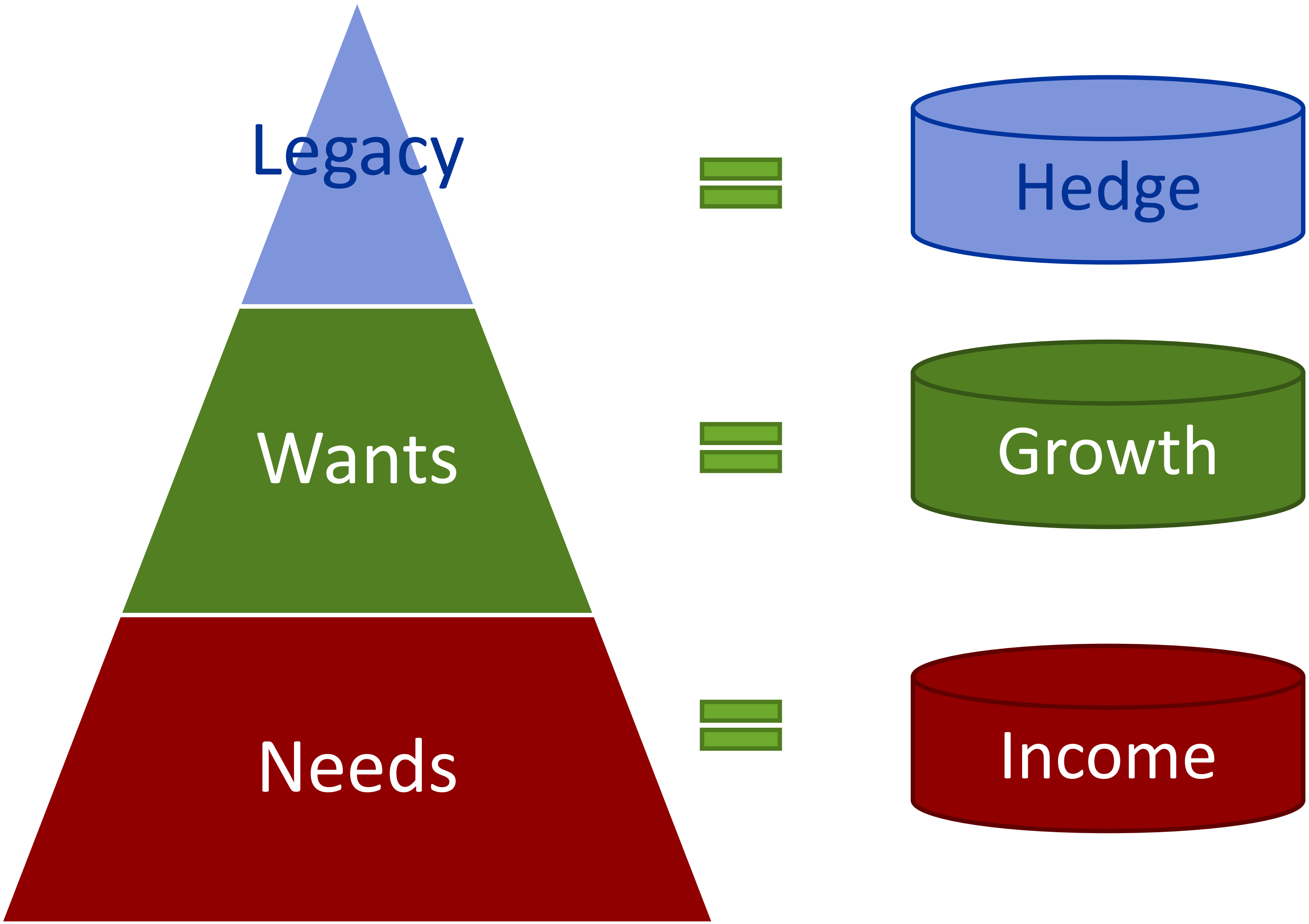
Whole Life:	$400,000

Real Estate Assets

Primary Residence:	$875,000

Total Assets: $10,274,796

Bucket Strategy



Reorganized

Cash Equivalents:	Income	Growth	Hedge	Total
Checking	$250,000	-	-	$250,000
Savings	$200,000	-	-	$200,000
Taxable Investments:				
Trust A (*xxxx)	$714,407	-	-	$714,407
Stock Account	-	$1,227,376	-	$1,227,376
Muni Bond Acct	$892,000	-	-	$892,000
Trust B (*xxxx)	-	-	$2,598,290	$2,598,290
Insurance Policies:				
Whole Life		-	$400,000	$400,000
Total: Non-Qualified Assets	**$2,056,407**	**$1,227,376**	**$2,998,290**	**$6,282,073**
Qualified Retirement:				
IRA (*xxxx)	$2,201,532	-	-	$2,201,532
Roth (*xxxx)	-	$916,191	-	$916,191
Total: Retirement Assets	**$2,201,532**	**$916,191**	**-**	**$3,117,723**
TOTAL LIQUID ASSETS	**$4,257,939**	**$2,143,567**	**$2,998,290**	**$9,399,796**
Total: Real Estate Assets	-	-	$875,000	$875,000
TOTAL ASSETS	**$4,257,939**	**$2,143,567**	**$3,873,290**	**$10,274,796**
Target Bucket Allocation	41%	21%	38%	

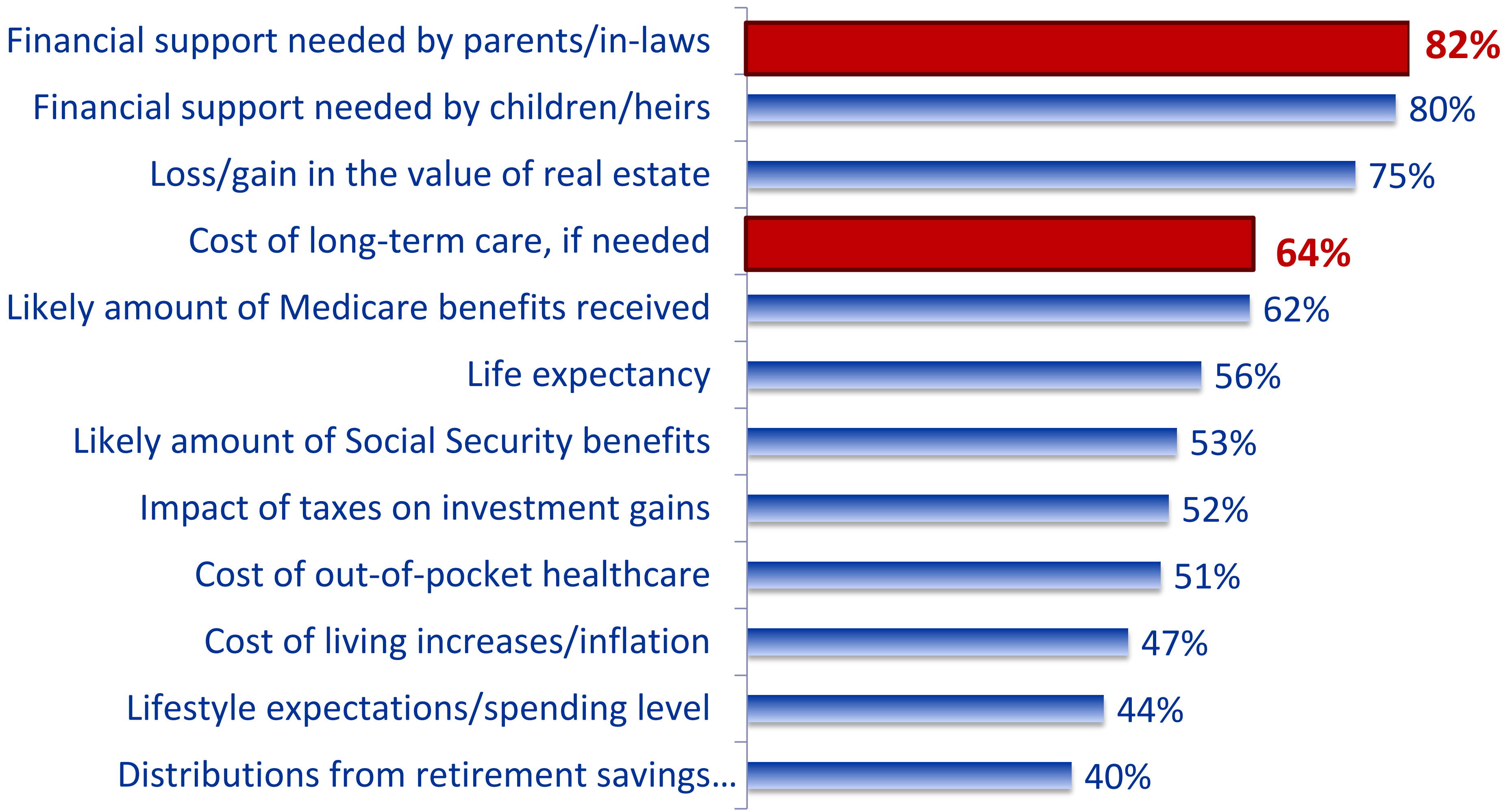
TARGET

Income	Growth	Hedge
62%	**28%**	**10%**

Other Variables to Consider

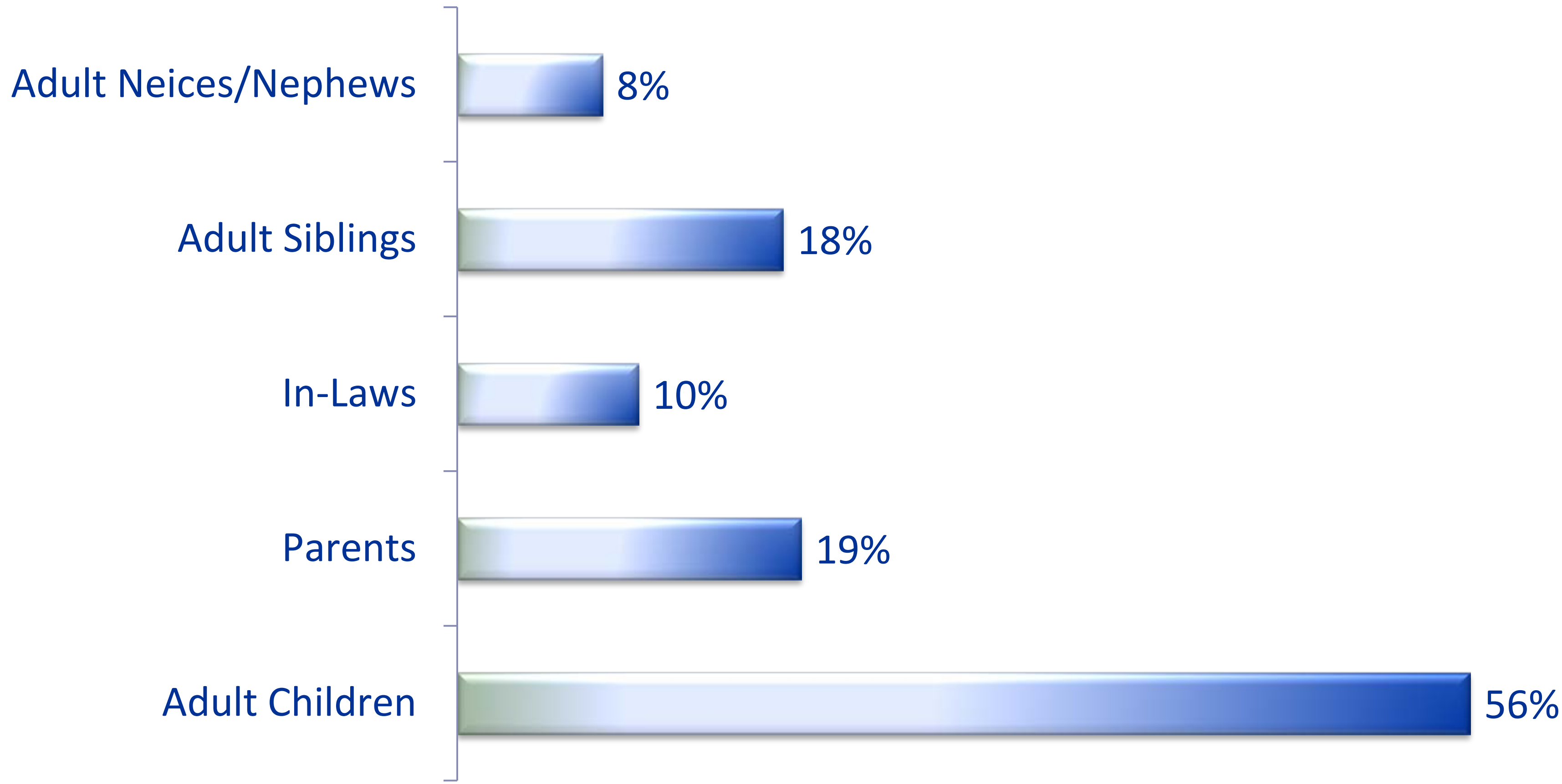
Sold right before or after the net market correction
Sold right before the worst bond market in a decade
Either the owner or spouse has to pay for health care for each other or one of their parents
Gets Divorced
Has or wants to pay for college tuitions (kids or grandkids)
Wants to gift a substantial amount of assets to kids or charity

Factors NOT accounted for in calculating retirement income



Source: US Trust 2013 Key Findings on Insights on Wealth and Worth

Percent who have provided substantial financial support to family members



Source: 2013 U.S. Trust Insights on Wealth and Worth

Defined Benefit Plan

Types of Plan	Benefits
401(k)	•Recruit •Competitive •Problematic as you grow •Source of funds for ESOP
Profit Sharing	•Recruit •Reward
Defined Benefit	•Unlock equity for owners & execs •Great for companies w/cash flow •Plateaued revenue growth
Non Qualified Plan	•Recruit •Reward •Retain

Examples of DB Plan

Can accumulate up to $2,000,000

Strategy	Contribution for Owners	Cost for Employees	Tax Savings @40%	Net Current Benefit (Cost)
Current Safe Harbor and 401(k)	$59,500	$26,580	$34,432	$7,852
Safe Harbor, 401(k) and top off with X-Tested Profit Sharing Plan	$105,500	$57,094	$65,038	$7,944
Combination Cash Balance/401(k) Profit Sharing Plan	$310,000	$100,358	$164,143	$63,785

Sale to current management

Potential Problems

- Owners are not risk takers
- No money
- Unwillingness to take on bank financing

Potential Solution

Build real equity in Non-Qualified Plans

Example: 15 HCEs participating

Deferring $10,000 each

\+ $10,000 Company Match

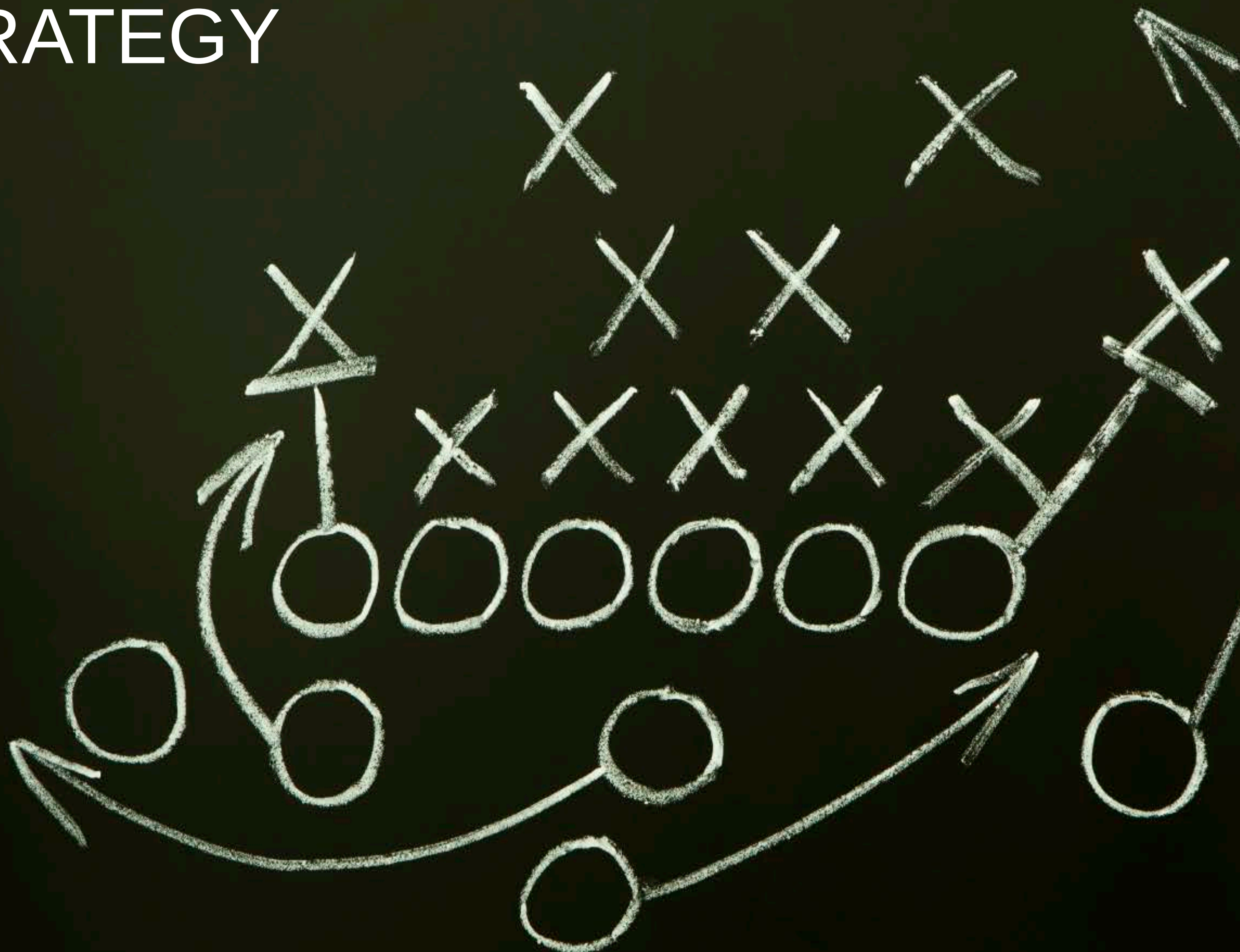
= $20,000 per year

× 15 HCEs

× 5 years

= **$2,000,000 - $2,500,000**

Alter Business Strategy



Grow revenue & Recruit talent

- ✓ Recruit Business Development professional in area of core competency
- ✓ Hire strategist to develop additional dimension in product offerings

- ✓Assessment of sector, sub-sector, or Agency/Department and program office attractiveness
- ✓Analysis of key budget themes, procurement trends, and market share leaders
- ✓Defining the current "as is" state and the desired "to be" directions
- ✓Identify multi-year trends and shape the "how" accordingly
- ✓Consensus building across all constituents (board, executives, line managers, staff) to engender buy-in and increase the probability of success
- ✓Multi-faceted analysis of quantitative and qualitative indicators (size, momentum, rates, vehicles, tenure, etc.)
- ✓Independent third party view of SWOT relative to other players
- ✓Holistic campaign including key hires, B&P, M&A, IR&D, teaming, etc.
- ✓Rooted in developing account plans, solution plans, and capture plans
- ✓Identification of partners and utilization of pricing and other "weapons"
- ✓Qualitative benchmarking of organization, talent, gaps, and compensation
- ✓Pipeline modeling tool yields quantitative analysis of pipeline size and shape
- ✓Deep understanding of prevailing rates across federal customers and offerings

Employee Stock Ownership Plan

Background

- Private equity demand to buy businesses has slowed so sellers need a flexible strategy locking in business value to achieve liquidity
- An ESOP is a type of tax qualified retirement plan with special features
- Large number of businesses and owners seeking liquidity and a long term plan
- ESOP offers an opportunity to achieve partial or total relief from federal taxes at the corporate level

Example

Fair Market Value = $10,000,000

Sell Half to ESOP = **$5,000,000**

- Potentially 0% taxes on transaction
- Company cuts taxable revenue *in half* on earnings

How to Grow a Healthy 401(k)…

…as an Internal Funding Solution

Considerations for Plan Design

1

- Use Auto Enrollment to increase participation and pass “testing issues”

2

- Reduce match ($.50 up to 4%)

3

- Remove HCEs from match to provide ultimate flexibility

Plan Comparison

Current Plan

Payroll	$6,000,000
3% - 6% Employee	$180,000 - $360,000
2% Safe Harbor	$120,000
Total	$300,000 - $480,000

GOV CON FLEXMATCH™

Payroll	$6,000,000
8% - 10% Employee	$480,000 - $600,000
4% Safe Harbor	
Total	$720,000 - $840,000

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5 Year Return on Current Plan with $2,000,000 in assets at 5% Net:

Current Plan

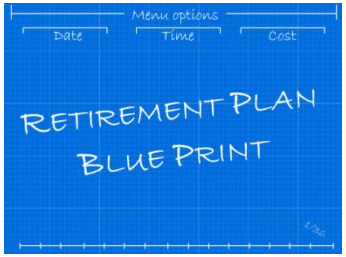
$4,000,000 -
$5,000,000

GOV CON FLEXMATCH™

$8,000,000 -
$10,000,000

Third Party Sale

Exit Strategy Alternatives for Government Contractors



Retirement Planning

Sale to Current Executives

Defined Benefit Plan

Modify Business Strategy

Employee Stock Option Plan

Third Party Sale

DB Plan | NQ Plan | ESOP

$2,000,000 + $2,000,000 + $5,000,000

Unlock the equity of the business

$9,000,000 +

30% Interest in Business

Thank You

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