



M&A SCIENCE

**THE FIRST CONVERSATION TO LOI
WITH KEN BOND**

The time between the first conversation with a target and signing the LOI is a buyer’s chance to make a strong impression. Knowing what steps to take and who to involve along the way is critical in order to stand out among other buyers, assess value alignment early, and gather support for the deal thesis.



Ken Bond
Head of Corporate Development – Cetera Financial Group

Joining Kison for this interview is Ken Bond, Head of Corporate Development at Cetera Financial Group. Ken will refer to decades of M&A experience as he walks through the basic steps involved in sourcing a target all the way through to getting them to sign an LOI/IOI.

Kison: Can you make a brief introduction of yourself?

Ken: I’m a lifelong corporate development professional. I started in 1996, mainly on the strategy side. I came from one of the big consulting houses, and then ultimately ended up on an in-house strategy team that transformed into an M&A shop. I spent about 13 years at Aon running their corporate development team and transitioned into Cetera about two years ago. I’ve done about 250 deals throughout my career.

Kison: What would you say are the key steps or milestones going from the first conversation through to the LOI?

Ken: If you want to be decent at getting deals across the end line and delivering a reasonable amount of volume for the organization, you must have a strong strategic transaction appetite.

If you have a clear strategic appetite, the universe of potential targets becomes significantly clearer. Utilize third party data sources / different databases or consultants to gain an understanding of what the universe list looks like. Also, remember to leverage the existing infrastructure and economies of scale in order to deliver services for acquired businesses

After that homework is done, build the sourcing team. We have a sourcing team that is staffed with very senior experienced hires in the wealth management industry. These are individuals that are probably nearing retirement or are retired and looking for things to do. They have a deep rolodex, know the industry, and have a feel for whether there would be a strategic fit.

They do the initial outreach to targets. Outreach needs to be done by somebody who is seen as credible to the targets. Presumably, we are talking about a very proactive search process as opposed to reactive – reactive being responding to processes that are being run by bankers.

Bilateral is the best way, evidence would back me up on that. If you look at outcomes, bilateral deals yield better outcomes than bilateral auctions.

Kison: You gave a good backdrop into the strategy, appetite, and alignment that allows you to shortlist potential targets that you will build into your sourcing list. When approaching the first conversation, how do you choose the correct person to do the initial outreach?

Ken: Pick someone credible. If I have my junior analyst simply dialing for dollars, it's unlikely to be successful in the context of what we're attempting to buy.

If we are buying a private seller, owner-operated business, it will most likely be the largest financial transaction that they ever do. The CEO or founder has probably been building the business for the past 30 years. They have likely spent more time with their business than they have their own family. They care deeply about their employees who may also be friends and family. They care about their clients a great deal as well.

When approaching the mindset of the sellers for a private seller transaction, remember that the sellers care about getting top dollar, their people, and their clients. **The initial outreach has to be aware and respectful of the seller's priorities.**

There are also sellers, such as corporate sellers that do carve-outs, that have very different priorities.

Kison: I wrote down, "Don't have analysts lead the charge".

Ken: Yes, in general, that's absolutely true, although I know some industries where that actually does work to some extent. Those are very hot industries where everybody's looking to sell. If you have a plethora of businesses that are looking for buyers, then perhaps that could actually work. But for the most part, have a senior person do the initial outreach and see if there is an appetite for a conversation.

Kison: You're not calling to say, "Hey, would you like to sell your business?"

Ken: The initial outreach should be, "Hi, would you like to have a conversation?". **The first touch is to try to get to know each other and understand their vision for the future of their business. Let the target guide the conversation. Depending on where the conversation goes, there might be an appetite to explore further.** That's the space you're trying to pull them into.

There are going to be objections along the way. The primary objection is that the business could be harmed if people were to find out that you were in discussion with them. Therefore, there is a bit of a hippocratic oath when you go through this, which is "do no harm".

Be credible when having those conversations with a target. Assure the target that any exploration between the two parties would involve a very small number of folks. This includes a handful of people from the corporate development team, and maybe the CEO and CFO. Reassure the target that it will not leak and that those conversations will happen safely.

As a demonstration, I typically lean on the fact that I've had 50 of those conversations already this year and no one has heard about any of them. There are ways to give proof points that you can do that successfully for the seller.

Kison: Once you get to that point, the question is, "How do we explore the art of the possible?"

Ken: The first thing to do is to promptly put an NDA in place. The NDA signing will almost always trigger certain things in the process. There may be steps in your corporate development process that notify certain people along the way.

In our specific process, another senior executive and I tend to the sourcing. Once we get the signed NDA, members of my corporate development team, such as the directors, get involved. We start doing some diligence to determine what the transaction structure and valuation would look like. You don't need much data for this.

Do not want to hit the target with a hundred due diligence requests. Instead, go for a

few important requests limited to historical financials and enough legal information to understand how to put the deal together.

The NDA will come to terms in coordination with how we're going to agree to exchange information. Usually, once this stage is reached:

1. Bring in a director and analyst, introduce them to the team and provide an initial data request list.
 - a. I make sure the seller understands that the information should be canned historical financials for three to five years, depending on the industry, as well as their basic legal structure.
2. Have a call with the bookkeeper to walk through their finances to make sure you understand what the financial statements represent.
3. Build or populate a valuation template.
 - a. Presumably, there are assumptions around synergies, both revenue and expense, that you need to make in order to get to that value.
4. Develop the LOI
5. Negotiate the LOI

This is where a lot of firms have challenges. There is a risk in delivering an LOI. Many people want to make sure they get a number as accurate as possible. However, an accurate number comes at the expense of speed and requires significantly more diligence than necessary.

Pre-LOI needs to reflect the cost of the full-blown due diligence effort (after you sign the LOI). You're going to spend a lot of money on external advisors, at least \$500,000 to \$1,000,000, in your diligence effort to get to definitive documents. Make sure that the LOI is pretty close to being in that ballpark.

If it's a smaller transaction where the diligence costs are significantly lower, take a bit more risk. An experienced corporate development team generally has enough knowledge to understand where the synergies are going to be, how to estimate the rough size and magnitude of each of those synergies and the viability of achieving them. The corporate development team can then come up with a pretty decent estimation after analyzing the synergies.

If you document your assumptions, structure, and value in the LOI, you have a basis for adjusting value. The key is to avoid seeming random or capricious.

You certainly don't want to be viewed as rerating value. If you've documented your assumptions in your LOI and those assumptions turn out to be false during the diligence effort, the conversation becomes difficult. However, you can take those findings back to the seller and adjust the value based on facts.

When I have an LOI put together, I highlight the assumptions that I have along with the big value drivers. In some instances, the sellers indicate: here is my revenue, EBITDA, number of assets, and key metrics. The key metrics can be non-financial metrics as well.

In your LOI, have a section on:

- Structure



- Value
- Contingent consideration or earnouts
- Assumptions
- Employees
- Legal structure
- Operations

The letter's intent is predicated all upon the following assumptions which have yet to be diligence.

In the financial section, list off revenue, EBITDA, etc. If the number of widgets being sold is an important metric and is the value's basis, then it should be included. You don't need to go to the level of granularity to list amortization and depreciation rates, but you do want to have top line numbers that will drive value.

Kison: What if your metrics relate more to people?

Ken: Of course! This begins the conversation around retention. The assumption is the management team will come over as part of the transaction and be retained through close, it doesn't necessarily need to be there.

Include sections on where employees and the management team will transition to post-close. Certain members will have agreed to employment contracts and the retention plan will be put in place to ensure that the management team is retained post-close.

The number of people involved in this stage is still low, as it is not full-on due diligence yet. The burden you put on the organization needs to be commensurate with the probability of a successful outcome. Since you're just doing an LOI, you do not want to be pulling in fifty people from the organization to help with the bid.

If it's a billion-dollar acquisition, that's a different topic. In a round one bid, the number of people involved is going to look very different compared to a round two offering where there is a full blown diligence effort. For small deals (anywhere from \$20 to \$150 million) leverage pre-existing models.

Kison: What's next and who is involved?

Ken: You always have two sets of eyes on a model, including internal counsel. At this stage, you probably are not even using outside counsel and are ball-parking to get the LOI out of the door, especially if it's a small deal.

If this is the first LOI that you've done, involve functional leaders. However, as you supersize the deal, review your assumptions with key functional leaders to make sure you're in the right ballpark.

Have a 30 minute or hour meeting with the functional leaders to walk them through the model. Bring the people you need to help pull the data request together for the target company. Bringing in advisors in the pre-LOI stage increases the likelihood of failure, and they cost money. The financial model is what gets us to the next stage, putting an LOI together.

Kison: We talked about aligning those assumptions. How do you approach aligning assumptions in the LOI?

Ken: This is where we talk about negotiation. **You are trading risk for value** (as is almost true in every negotiation). They will want to push risk to you and will want value in exchange. Try to find the middle ground that allows both parties to be equally happy or unhappy. In professional services organizations, this is especially the case as people are the largest asset of the firm.

Oftentimes the way to bridge the valuation gaps is by using contingent consideration or earn outs where you were basically saying, *“I hear that you want a multiple of X. I’m only willing to pay Y. To believe the business is worth the multiple of X, it would need to grow at a specific rate. I will pay a portion of the value at close, and the rest of it as an earn out contingent upon your ability to demonstrate that the business is actually capable of growing at the levels that you indicated can. If you achieve those growth rates, I will pay you some additional consideration in years 1, 2, 3, and 4.”*

That is an easy way to bridge valuation gaps between a buyer and seller. However, as a bit of a warning, earn-outs can go bad quickly if they are not properly documented, structured, and premeditated. Hire counsel to help if you haven’t conducted an earnout before. Counsel is critical as they understand how to structure earn-outs. They can have unintended consequences on integrated entities as well. For example, if you’re integrating a new team into an existing team, and if they both have sales functions, it could cause disharmony if only part of the team is subject to earn-outs.

There are different considerations that need to be thought through when conducting these types of structures. What are the trigger events that cause the earn-out to be paid? Examples of trigger events include a financial metric like a revenue growth rate or an operational metric like the number of clients or the number of widgets sold. There are a lot of different ways to approach earn-outs.

Kison: Are you for or against using earn-outs?

Ken: I think they motivate the right behavior. We have enough scars so we know which mistakes not to repeat. We have enough experience to use earn-outs safely. They can lead to some true horror stories. Every conference we go to has someone sharing a story about how they structured an earn-out and it blew up in their face. **Having a competent counsel to help you structure earn-outs appropriately is critical.**

Kison: How does an economic crisis, such as our global pandemic, impact earn-outs?

Ken: An economic crisis is a market risk or variable just like any other. Depending on how you’ve agreed to share risk with a seller, an economic crisis is one of the risk factors that will have to be taken into consideration. All types of risks boil down to the framework that was adopted in the transaction.

Kison: How do you deliver the LOI?

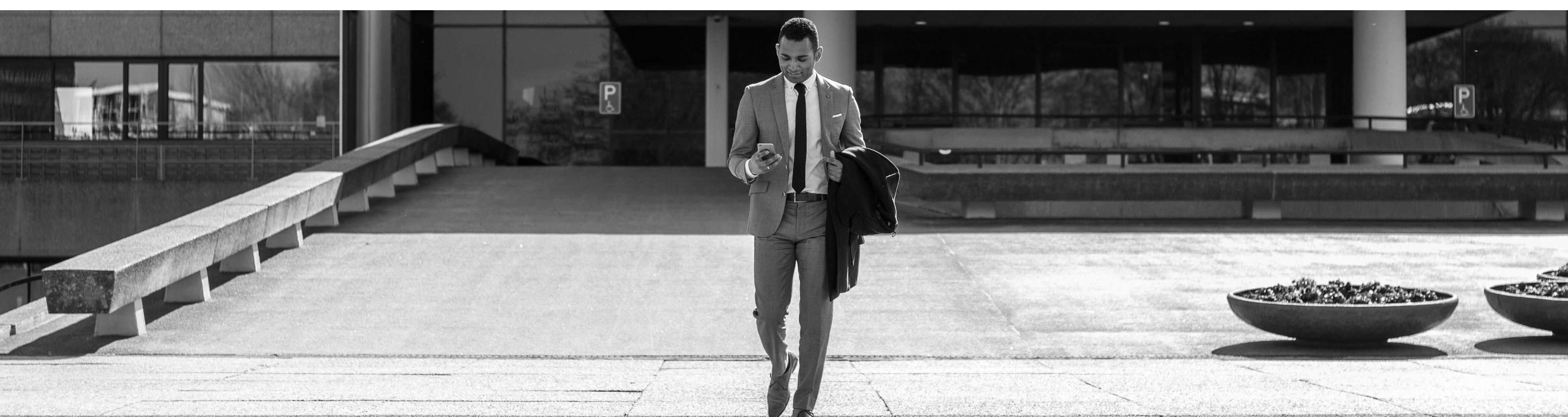
Ken: We make an LOI look as formal as possible. Generally, the LOI is just a good optic value; it looks official. There is a lot of an LOI that can be reused. There is always a background section of who you are and why you’re a wonderful firm and a good acquirer. Even if they are someone who is friendly and has known you for thirty years, reiterate who you are and deliver your best show. Typically, we have already had a value conversation with the seller by the time the LOI is executed and delivered.

We step the seller through a couple of different conversations before the LOI is delivered to them. The first conversation occurs after we obtain the financial metrics and build the P&L, including our suggested adjustments. We do this so we can get an agreement with the seller around the numbers we’re bidding off of, and get them to just put a stake in the ground that says, “Yes, my EBITDA is \$X”.

That is very valuable. After locking down the numbers, have a conversation about transaction structure and how the consideration would be delivered. Walk through what the structure would mean for the seller and how long they need to stay through the earn-out period. List the employees or sections that need to stay. Have the structured conversations as verbal discussions, preferably in-person or over Zoom, so you can gauge their response.

If they react negatively, then there is no need for the LOI. If they react neutrally or positively, then you have a good amount of presentation around the actual LOI language.

Kison: How long is the LOI?



Ken: An LOI is anywhere from five to eight pages. For big transactions, the LOI can be 15 pages long. For a simple transaction, the LOI can be a couple of pages.

1. The first couple of pages are surrounding the background of the firm, history, and the values they will care about.
 - a. You want the target to believe you are a mature acquirer that has bought and integrated a lot of companies.
2. The second part is the non-binding proposal of how it will be structured.
 - b. Here's how we value your firm.
 - c. Here's what shareholder proceeds would look like based on the balance sheet that we have.
 - d. Here are the assumptions that went into our evaluation.
 - e. Here is what we will do with the employees.
 - f. Here is how we would integrate the firm.
 - g. Here's what operations would look like post-close.
3. The end is the confidentiality paragraph, a description of the non-binding nature, and finally ends in the exclusivity paragraph.

You arrive at the five at eight pages easily.

Kison: How do public company deals happen?

Ken: Public company deals happen differently than what we're talking about here. You could argue that there are three different processes. There are the bilaterals where we're talking with other private companies about potentially acquiring them (which is the process this article is about). The other process would be a corporate carve out. That is a slightly different process, mainly on the sourcing side.

With bankers, you receive a high volume of inbounds through an auction process and that process will be much more scripted. You will receive a process letter. The process letter will spell out what they want to see in your bid letter which behooves you to deliver a compliant bid response. Make sure you touch on each and every item that they have questions about.

Kison: With carve-out sourcing, what makes that different? Are you rubbing elbows with other leaders to find those opportunities or CEOs?

Ken: Absolutely, you are reaching out to them. Source those deals just like you source the other ones. The sourcing leader is probably leaning on the corporate development team to set up conversations with other corporate development leaders. Ask them if they've gone through a strategic review or if there's an appetite to even look at what the art of the possibilities could be with a division that their competitors have sold in.

You may see that a segment or business unit within a certain industry is frequently being sold at the moment, which could make the continued ownership of a specific segment no longer attractive.

Now, not everybody in the industry may have come upon that revelation or believe that is the correct outcome. We're gonna call those folks and make sure that they're seeing the same rationale that other folks have seen. The way to approach them more often than not is to acknowledge that they are probably going through a strategic review process either expressly or implicitly through the budgeting process every year.

It would be certainly helpful if they had real numbers when making decisions about whether they should be retaining a business unit or exploring strategic options. You're not engaging with them at that time to actually have them come to a realization that they want to sell the business to you.

Make a decision about value. If we give you a real view of value, you can then use it in your buy as opposed to hypothetical numbers with which an industry participant may value your business unit. You can engage bankers to run a process if you're trying to get in early so you can influence that outcome. Rarely, but in some instances, a corporate publicly traded entity may decide to sell that division to you without going through an auction process.

They frequently have a fiduciary duty that they need to meet in order to get fair value, and that almost always requires them to go through some type of auction process.

Kison: What other things are negotiated on the LOI? Do you insert a 5% padding on the buy price?

Ken: I do not open with my final value number. I always leave myself wiggle room so I can negotiate. I also don't want to be overly conservative. I don't want to have to be in a position where I have to pull my offer.

If I'm overly conservative, I can turn off my bidder, and then they won't engage with me. Especially if they feel offended by my valuation. If it's a competitive auction, I won't make it past round two.

Ensure them that you're delivering a good value, while still having enough room to maneuver any other term.

- Is it an equity deal or an asset deal?
- Does it require any unusual deals or are there any unusual deal structures that you're going to need to negotiate?
- Is there a key employee that you need, right?
- Is there a key management team that you need?

Anything that is front and center or critical to a deal has to be in there. I was trained to never put the price first. This is my number one rule in negotiations.

Kison: If there is an opportunity to really get a good deal, how do you get that intel?

Ken: You will figure that out in your initial discussions with them about what is motivating the transaction. Targets almost always have a list of priorities outside of just transaction value. Rarely, they will say, "I want to maximize purchase price". Even if they say that there are other things as well.

Do they want to continue to engage in the business? Do they want to retire? Are they looking to spend more time with their grandchildren? Are they looking to start a different business or enter into some other new chapter of their life? Are they going to open a coffee shop?

All of that matters and influences the terms that you can offer. You don't need to have the highest purchase price to win the deal. Especially if you can fully address the other considerations that are highly important to the seller.

This is why the initial conversation steps through financials in order to come to an agreement around their EBITDA. Almost always, there is a number that you've missed or an unanticipated one-time expense. Especially if they are the owner and operator of their business, there are personal expenses that are flowing through their P&L that wouldn't continue post-close. Make sure you're getting the right performance adjustments in there.

Once you have agreement around the numbers, it's hard to argue. The risk that your deal is offensive goes down dramatically because of market multiples. It is all about how you build confidence with some real evidence around your value.

Kison: I wanted to ask you about speed and accuracy.



Because we put this purchase price on the front end and I feel like the whole effort of diligence uncovers so much, then we look at what we do to get to that LOI purchase price. How do you get these assumptions dialed in, in a way that you're getting a bid on the table quickly, but accurately and without missing some big capital expenditure or synergies?

Ken: What I would argue is that you have some historical financials you're making assumptions about what the CapEx is going forward. You also make assumptions about the target's balance sheet, revenue, and EBITDA.

From there, build your P&L by stating those assumptions to the extent that confirmatory diligence reveals. If you uncover alleged one-time expenses that are in fact recurring, then you've got a basis to go back and adjust the value.

Coming out with a bid is important, and you can get a lot of the accuracy needed at that point for it to be sufficient. Again, the basis isn't absolutely getting the right number. The goal is to provide a number that has a solid basis from which you can make adjustments.

If it takes forever to do pre-confirmatory diligence to get to an LOI, you are sending the signal to the seller that you are a difficult negotiator and that it will take forever to get through confirmatory diligence. If it took three months to negotiate an LOI, how long would it take to get definitive documents?

In addition, the faster you are, generally the fewer internal resources you're consuming to get there. That means more LOIs with the same amount of resources and it costs the organization less.

Kison: I assume that these conversations get easier the more you do them.

Ken: For example, let's say you're in confirmatory diligence and you bid on Q1 earnings. As you run through diligence and Q2 becomes posted, what happens if the results were different than expected?

You should adjust your purchase price if the numbers have come down. This way, you have a solid basis for doing that because the EBITDA has moved. If the EBITDA came down 10%, your purchase price should come down 10%.

The LOI is your chance to impress the target. For the deal thesis to be supported, it's critical to know what steps to take and who to involve along the way, and these are all details that can help. Take it from a lifelong corporate development professional.





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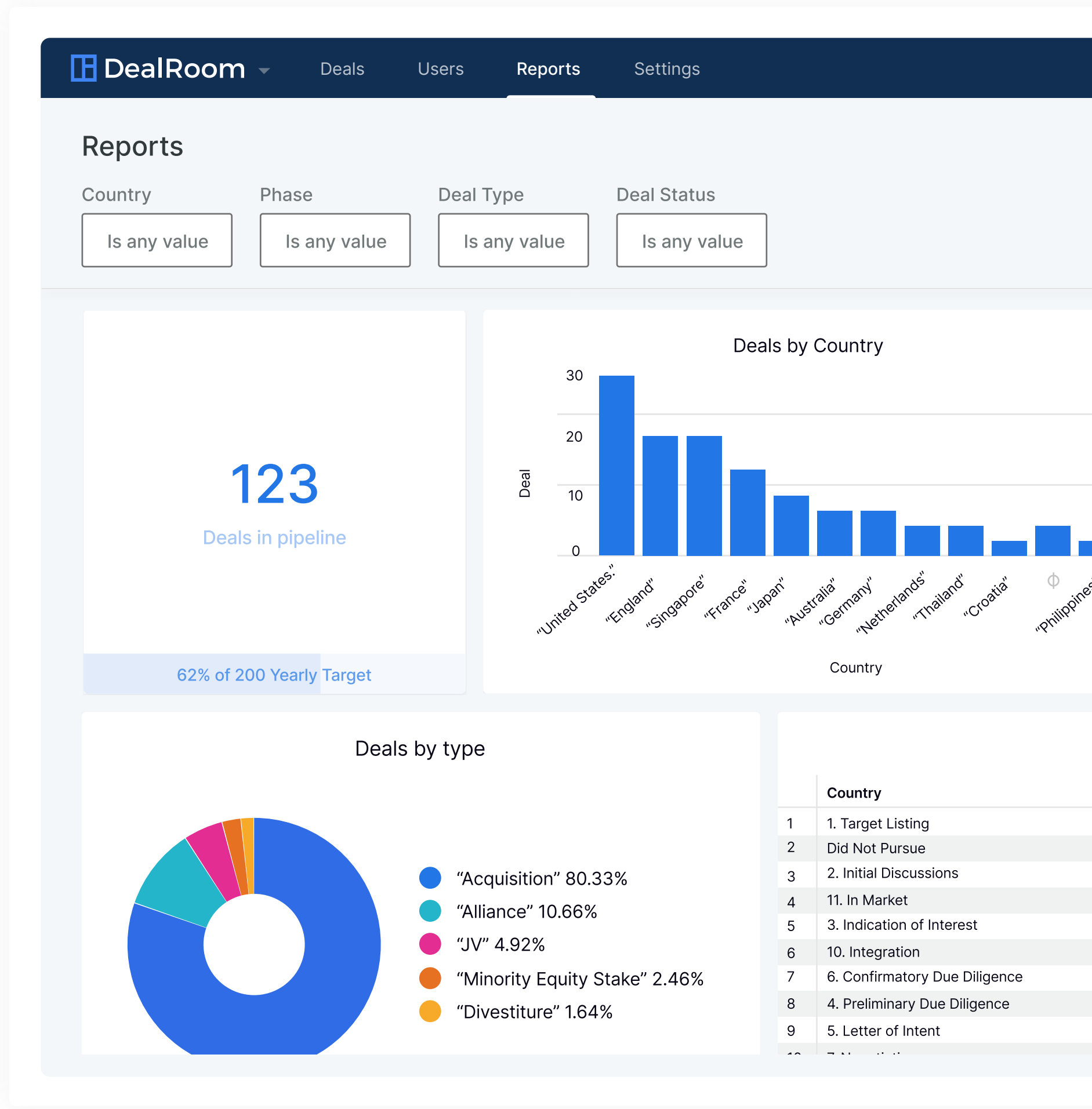
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