

Links Capital Partners is an independent corporate finance firm focused on providing advice on acquisitions, divestitures and financings to middle-market businesses



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**ACQUISITIONS
DIVESTITURES
FINANCINGS**

Links Capital's M&A Perspectives

It has now been over a year now since bankruptcy of Lehman Brothers triggering a global economic meltdown. Throughout the last year numerous companies went bankrupt while others saw their revenues and earnings evaporate. Now we are in an environment where private equity investing in distressed companies is a growth area. In the third quarter, distressed investing accounted for 10% of total private equity deal flow compared to 2% in 2008.

Prior to the meltdown many companies had acquisition mandates where they took advantage of low priced debt, leveraging their balance sheets and getting deals done. It was not unusual to see companies attaining up five and six times EBITDA in debt and in some cases financed acquisitions totally with debt. A lot of these acquisitions ended up getting done with smaller than usual equity investments.

Where does it leave these highly leveraged companies when business conditions soften? These companies are not only faced with trying to renegotiate terms with their lenders, they will have to justify the value of goodwill on their balance sheet running the risk of potential goodwill impairment at year end. Since most of the acquisitions are based on earnings and this may have eroded, the current value of the acquisition may also have fallen. Goodwill as an asset will likely have to be adjusted on the year end financial statements. What does this adjustment of goodwill mean for these companies?

This newsletter highlights:

"How goodwill gets on the balance sheet and how it is treated?"

What is goodwill and how does it end up on your balance sheet?

Goodwill is often referred to as an intangible asset that sits in the asset section of the balance sheet. When a company acquires another company at a price in excess of the net tangible assets, the amount over the net tangible assets is considered goodwill. The price difference may be because of brand recognition, an excellent customer base, supply relationships or potential synergies. In reality goodwill occurs because a company is often valued using a multiple on some kind of earnings whether it is EBITDA, sustaining cash flow or earnings and this value exceeds the net tangible assets of the company.

In the example below, a company generating \$12 million in EBITDA has an enterprise value of \$63 million if you apply a 5.25x multiple to the EBITDA. If there are \$50 million in tangible assets in the company, the goodwill would amount to \$13 million.

EBITDA	12,000,000
Multiple	5.25
Enterprise Value	63,000,000 a
Tangible Assets	50,000,000 b
Goodwill	13,000,000 c=a-b

Experience in the areas of Private Equity, Investment Banking, Valuations and Corporate Lending enhances value to our clients.

The diversified financial background combines various ideologies in positioning our clients to maximize value in their business, whether it is the sale of a business, bringing on a financial partner, or attracting additional capital, Links Capital can help.

Links Capital's philosophy is to preserve value throughout the entire transaction process. Only senior executives will handle all aspects of the transaction from inception to close, avoiding potential value loss by not having less experienced junior analysts involved in the transaction.

Typical transactions range in size up to \$250 million which are ideally suited to middle-market businesses. Links Capital's management has been successful managing capital on behalf of government, provincial pension funds, insurance companies and high net worth investors in completing mergers, acquisitions, divestitures and financings for both private and public companies.



Links Capital

Divestitures • Acquisitions • Financings

At Links Capital Partners, we focus exclusively on assisting our clients sell, buy and finance businesses.



Goodwill must be valued on an annual basis. At the end of each fiscal year it is incumbent on the company to do a valuation of the company to prove that there has not been impairment in the goodwill amount. Given the recent downturn in the economy looking at the same example, what happens if earnings erode by 20%? Also, without going into detail there has been multiple compression as deals are not getting done at the same multiples that were getting done a mere 24 months ago. This multiple compression may also impact the amount of the goodwill impairment.

Assuming earnings of the company erodes to \$10.0 million EBITDA and the valuation multiple decreases to 5.0x, what happens to the company and its balance sheet?

<i>EBITDA</i>	<i>10,000,000</i>
<i>Multiple</i>	<i>5.00</i>
<i>Enterprise Value</i>	<i>50,000,000 a</i>
<i>Tangible Assets</i>	<i>50,000,000 b</i>
<i>Goodwill</i>	<i>0 c=a-b</i>
<i>Previous Goodwill</i>	<i>13,000,000 d</i>
<i>Goodwill Impairment</i>	<i>-13,000,000 e=c-d</i>
<i>Reduction in Equity</i>	<i>13,000,000</i>

The reduction in goodwill immediately must offset the equity on the balance sheet resulting in retained earnings being reduced by the amount of the goodwill impairment.

Now from a banking perspective, banks typically net off any intangible assets in the calculations of their banking covenants. So one would think that there is no issue if the banks netted off goodwill before and now it is written off, doesn't that just save the bank time in calculating their covenants. That is a correct statement but the perception may be different in the eyes of the bank's credit department at some later point in time.

Assuming a leveraged company that had \$8 million in equity before the goodwill impairment, the banks would likely view the company as generating \$8 million worth of capital in the company over the years. The equity value on the balance sheet has come from share capital or retained earnings.

When goodwill impairment occurs as with Company B, nothing has changed from a banking perspective. However, when one looks at the balance sheet it may be viewed differently. The impairment reduced the equity significantly to a negative position bringing up the question, where is that capital the company generated, yet nothing has changed.

<i>Company A</i>		<i>Company B</i>	
<i>Assets</i>	<i>50,000,000</i>	<i>Assets</i>	<i>50,000,000</i>
<i>Goodwill</i>	<i>13,000,000</i>	<i>Goodwill</i>	<i>0</i>
<i>Total Assets</i>	<i>63,000,000</i>	<i>Total Assets</i>	<i>50,000,000</i>
<i>Liabilities</i>	<i>55,000,000</i>	<i>Liabilities</i>	<i>55,000,000</i>
<i>Equity</i>	<i>8,000,000</i>	<i>Equity</i>	<i>-5,000,000</i>
<i>Total Liabilities & Equity</i>	<i>63,000,000</i>	<i>Total Liabilities & Equity</i>	<i>50,000,000</i>

What does this all mean?

Issues and concerns described with goodwill impairment may not occur at the time of the write-down but at some later point in the future. You may be looking at refinancing some debt, increasing your line of credit or even entering into a possible transaction to buy a business. The perception of the impaired balance sheet may be looked upon differently when compared to the balance sheet before the impairment even though from a banking perspective nothing may have changed. However, the fact is the owners of the balance sheet ended up paying a sum of capital in the past for something that has eroded in value. These reductions in goodwill may also bring into question some of management's decision making.

This newsletter as an example only brings out some of the current issues with business valuation and financing. Your decision to undertake a business transaction is a major business decision, that's why we've committed ourselves to overcoming the obstacles you would typically face - **creating incremental value and making the process less disruptive to your business.**

Links Capital Partners is a professional firm focused exclusively on **Selling Businesses, Raising Capital** and assisting our clients **Acquire Businesses.**



Links Capital

100A-9705 Horton Road SW Calgary, Alberta T2V 2X5
Phone: 403.538.5109 | www.linkscape.com

Ron Chicoyne CFA, CF
rchicoyne@linkscape.com

Michael Cook CA, CBV
mcook@linkscape.com