SP Equity Case Study

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This case involves an entrepreneur who raises a search fund to pursue the acquisition of a software firm. It is intended for the deal structure segment of an entrepreneurial finance course, as it illustrates stages of financing, returns to investors, layering of debt and equity, and valuation, as well as the search/acquisition process. The case is positioned with the entrepreneur having found an "ideal" company to acquire; however, three days prior to closing, he has uncovered some information the seller had been trying to hide. He now needs to decide whether he should continue with the deal.

INTRODUCTION

Steve Pepperman stared at the spreadsheets on his laptop. It was nearing midnight on May 28, 2008, and he was supposed to be closing a $20 million purchase of a software firm in three days. Sixteen months earlier, after enrolling in a private equity course at the University of St. Thomas, he had embarked on a journey to find and acquire a company and had thought he found the ideal firm. But earlier that day, Steve uncovered some unsettling information about the company's revenue growth over the previous five years: it had not come from the acquisition of new customers as the previous owner had led him to believe, but rather from conversion of existing customers to a new version of software. Steve's projections had been based on the assumption that he would be able to increase the company's market share and now he was not sure that assumption was valid. He would have to disclose this finding to his investors tomorrow and he was certain they would not take the news well.

STEVE'S BACKGROUND

Steve was born and raised in Duluth, Minnesota, with a twin brother and seven other siblings. He was a third generation entrepreneur with both his father and grandfather starting and running successful businesses. An excellent athlete growing up, Steve was consistently ranked in the top three in the USTA Northwest junior tennis circuit, was the Northern Intercollegiate tennis champion in college, and earned his black belt in karate. He also showed an early interest in entrepreneurship by using money earned from a paper route to buy rental property the summer after his high school graduation. This investment was a great learning experience for Steve and he eventually broke even on the deal two years later after selling the property.

Steve attended the University of Minnesota-Duluth and studied computer science/math (see resume in Exhibit 1). Upon graduation, he obtained a position with UNISYS Corporation and eventually worked his way up from Software Engineer to Director of Product Development, becoming one of the youngest directors in the company. He left UNYSIS to become Director of Operations for Zubaz, a fast-growing company in athletic apparel, where he helped to groom the company for two years before it was sold to a Hong Kong investor. After Zubaz, Steve built a software-based scheduling system for the sports recreation industry in his basement, grew the business to over one-hundred customers in two years, and sold it to Sierra Digital in 1994.

Steve then spent the next twelve years in various managerial positions for technology-based companies. Between 1996 and 2001, he groomed two $10 million divisions of Epicor Software in Irvine, California. He led the sale of one of these divisions to the founders of Sun Microsystems and negotiated a term sheet on the other division with a buyer prior to his departure from Epicor. Between 2003 and 2005, he led a start-up division of Software Systems OTC and grew revenue from zero to $1 million in thirteen months. He was named Vice-President of M&A in 2005 and was responsible for identifying potential acquisition targets, performing due diligence, and negotiating acquisition deals. In this position, he entered into discussions with over seventy-five acquisition targets, issued letters of intent to seven firms, and closed deals on a $3 million German firm and a $23 million California firm.

OPPORTUNITY IN THE SOFTWARE INDUSTRY

While working for Software Systems OTC, Steve observed two trends in the software market that presented a promising opportunity. The first trend was that private equity funds were focusing their efforts on acquiring software firms with revenues above $20 million and EBITDA greater than $4 million; firms below this level were considered too small. Because of this, there was less competition for smaller software firms, which kept acquisition prices affordable.

The second trend was the conversion from legacy software to On-Demand or Software as a Service (SaaS) applications. In the legacy software model, software is installed on a customer's server, and revenues are generated via licensing, professional service, and maintenance fees. While profitable, this model results in unpredictable revenues from year to year because of the heavy reliance on upfront fees from new customers. In the On-Demand model, applications are hosted by the software provider and customers rent access to them on an annual or monthly basis. This model generates predictable recurring revenue for the software provider and results in lower costs for both the provider and customer. Because of its attractiveness, a large-scale shift to the On-Demand business model was occurring; however, because of the required investment, many smaller lifestyle software firm owners were opting to sell out rather than making this conversion themselves.

Steve knew from his M&A experience that legacy software firms with were typically being acquired for 4-6x EBITDA, while On-Demand firms were commanding 8-12x multiples (see Exhibit 2). Given the current trends, Steve believed that he could purchase a small, lifestyle legacy software firm for 4-6x EBITDA, invest in On-Demand technology, grow revenues and margins, and sell the firm for 8-12x EBITDA in three to five years. Steve believed this would be attractive to investors, and could provide an internal rate of return of 30-60%.

THE SEARCH FUND

Steve was introduced to the search fund concept in an MBA private equity course at the University of St. Thomas in the spring of 2006. In this course, he was taught the fundamentals of staging financing (first for the search process, and second for the acquisition), how to use debt leverage to increase the exit value for investors, and how to structure a deal that would be attractive to himself and to his investors. Most importantly, he realized in this class that starting a search fund was something *he* could do successfully.

Steve learned that the search fund model has two main objectives for targeting an acquisition that are the basis for success. One is that the cash flows of the business (for which EBITDA is an approximation) provide a basis for a debt lever between 30% and 60% of the total acquisition price. The cash flows of the business are then used to pay off the debt over a five- to seven-year period, creating value for equity holders if the exit can produce at least what was paid for the business. The second basis for success is that the right management/leadership is in place to run the acquired business. With Steve's acquisition and management experience, he believed he could fulfill both of these objectives by finding a business with strong cash flows and by taking over the CEO position of the acquired business for the duration of the investment.

In the six months following this class, Steve researched the software industry and began preparing a Private Placement Memorandum for a search fund called SP Equity (see Exhibit 3 for excerpts). His plan called for $360,000 of capital, which would fund an eighteen-month search. He resigned from his position at Software Systems OTC and began spending one-hundred percent of his time raising money for his search fund.

Steve approached friends and family with the opportunity, as well as several private equity funds that would have additional capital to invest at the acquisition. His strategy was to approach funds that did not have any software companies in their portfolios and sell them on becoming their high-tech partner. This proved to be a very successful strategy: Steve was able to raise the money in sixty days and ended up turning down eight private equity funds due to over-subscription. The deal was closed on December 15th, 2006, and Steve began the search that would put him in negotiations with Lending Specialist Technologies (LST) sixteen months later.

FINDING A COMPANY

Steve began his search by purchasing a database of all the known software companies in the U.S. and partitioning the list into revenue levels and geographic regions. Knowing that larger high-tech companies typically spawned smaller businesses, he focused on seven metropolitan areas: San Francisco, Los Angeles, Boston, Atlanta, Minneapolis, Phoenix, and Dallas. Steve also identified several vertical niche software industries he felt were ready to make the shift to On-Demand technology. He then attempted to get introductions to business owners, recalling from his M&A experience how critical third-party introductions were: "Small business owners are excited about receiving a big check in an acquisition but also feel guilty about leaving employees with a new owner; having a connection to the potential acquirer helps to alleviate this concern." Steve spent a great deal of time introducing himself to law and accounting firms, regional M&A firms, boutique investment banks, state associations, and other organizations that would know these small software company owners.

In sixteen months, Steve contacted ninety companies, performed due diligence on sixty-three, and made offers on seven. As the search went on, Steve felt more and more pressure to find a company. One aspect that was particularly frustrating to Steve was that writing a letter of intent and getting a deal closed was "like comparing the running of a 5k to a marathon": there was a tremendous amount of work to do after the LOI was written, considerable legal fees and other costs, and a significant chance that the purchase would not happen. There were two companies in particular that Steve thought were done deals that fell through. One case was a company that was a division of a larger firm: "The firm decided they wanted to keep the intellectual property and license it to us after we purchased the division. That didn't make any sense because we wouldn't have anything of value to sell in the end."

Steve came across LST in March 2008 through a relationship with a small boutique investment firm he had built in the beginning of his search quest. A partner at the firm called Steve to say that he had found exactly what Steve was looking for. Steve initially responded that he did not have time to look at it, as he had two LOI's out on firms in Dallas and San Francisco and was swamped with due diligence. However, the partner insisted Steve take a look at it because it was in a vertical sector in which Steve was interested, fit his model ideally, and already had a web-based software product in place. Additionally, despite its On-Demand infrastructure, the company's asking price was only 6.5x EBITDA.

LENDING SPECIALIST TECHNOLOGIES

Company History
Bob Benson founded LST in a small Midwestern town in 1985 as a consulting firm to assist farmers with agricultural bank loans. He quickly recognized a need for loan process management and developed a system focused on the agriculture segment. In 1996, LST converted the product from DOS-based to Windows-based, and in 2001 the company introduced a web-based platform. In 2005 and 2006, the company expanded into three other vertical markets: Commerical/Industrial, Commercial Real Estate, and Construction/Development. This led to a break-out year in 2007, as banks looking for capabilities beyond agriculture were now more apt to become customers (see Exhibit 4 for historical income statements).

Products
LST's loan-origination system had five main functional attributes: 1) Global System Encapsulation, which included loan process task management, integration with bank systems, and record-keeping; 2) Information Management, which included customer relationship management and entry of financial information for customer loan applications; 3) Financial Analysis, which included credit analysis, external credit report downloads, risk and approval processes, and credit analysis presentation; 4) Back-End Reporting and Interfacing, which included loan correspondence, loan portfolio reporting and analysis, loan status tracking, and monitoring of loan covenants; and 5) On-Demand Architecture, which allowed customers to either host the system internally or to rely on LST to host the application.

The value of the system to lending professionals was a more streamlined, standardized loan-management system that assisted in evaluating and monitoring loans. The system was designed to help banks to issue fewer risky loans, to automatically identify issues with loan customers (such as defaults on loan covenants) so they could be dealt with in a timely manner, and to act as a complete record-keeping database.

Market Segments

Commercial Banks and Savings Institutions
As of March 31, 2008, there were 8,496 commercial banks and savings institutions in the United States with over $13 trillion of assets. This segment was highly fragmented on the low end: the largest 1.5% of these institutions possessed 78% of all assets, leaving just 22% of assets to be divided among the remaining 98.5% (Federal Deposit Insurance Corporation, 2008). This customer group was the most promising for LST, as these institutions had loan activity in all four of LST's vertical markets.

One potentially concerning trend in this segment was that of consolidation, as LST's target customer was smaller banks and savings institutions ($50 million to $10 billion in assets). Between 1984 and 2003, the number of these institutions in the United States declined by almost 50%, and nearly all of the banks lost had less than $1 billion in assets. Over this time period, mergers and acquisitions accounted for the loss of 8,122 banks and another 2,698 banks closed. However, this decline was somewhat offset by the 3,097 banks started over this period (Jones and Critchfield, 2005).

Within the commercial bank and savings institutions customer group were Farm Banks, defined by the American Bankers Association as banks with less than $1 billion of assets and a ratio of domestic farm loans to total domestic loans greater than or equal to 14.20%. Of the 8,496 commercial banks in the U.S., 2,247 fell into this classification. These banks had $151.7 billion in loans outstanding in 2007, of which $50.1 billion were agriculture-related. This represented 38% of all agricultural loans (American Bankers Association, 2008; Cofer, Walser, and Osborne, 2008). As approximately 68% of the current LST customers were farm banks, this was an important customer group for the company.

Credit Unions

At the end of 2007, there were 8,101 credit unions in the United States that held $754 billion in assets (National Credit Union Association, 2007). Federal regulations limited commercial lending by credit unions to 12.25% of total assets (Drukas, 2008) and only 35% of credit unions currently offered business services (Credit Union National Association, 2008). On the other hand, there was a trend toward more commercial lending in credit unions, with total commercial loans increasing by 24% between 2005 and 2007, to nearly $3 trillion in loans outstanding (Credit Union National Association, 2008). Credit unions were potential customers for the agriculture and commercial/industrial products, but not for the other verticals. Approximately 5% of LST customers were credit unions.

Farm Credit Associations

Farm Credit Associations (FCA's) are part of the Farm Credit System initiative of the U.S. government, which provides funding and affiliated services to farmers, ranchers, producers of aquatic products, and other related businesses. Through 2007, the Farm Credit System had over $143 billion in loans outstanding (Federal Farm Credit Banks, 2008). FCA's were potential customers of LST's agriculture product, but not of its other vertical products. Of the ninety-five Farm Credit Associations, thirty-nine were currently LST customers.

Customer Base

LST's web-based software served 332 banks, credit unions, and farm credit associations with asset sizes ranging from $10 million to over $200 billion. The firm's largest two customers accounted for 45.1% of its annual recurring revenue (37% and 8.1%, respectively). No other customer accounted for more than 1.5% of recurring revenue.

The customer base for LST was predominately in the Midwest and Central regions of the United States, with 298 of its 332 customers located in these two regions (see Exhibit 5). Customers in these two regions also accounted for 49% of recurring revenue (LST's largest two customers were outside of these regions). However, market penetration in the Midwest and Central regions was relatively low, at 4.5% and 6.2%, respectively. Outside of these two regions, LST did not have more than 1% market penetration in any one region. The company also had eight customers in Canada and one in Australia.

An important statistic regarding LST had to do with its customer retention. Since 2001 (when LST introduced its web-based platform), the company had only lost eleven customers, all of which resulted from bank failures or bank acquisitions. This translated to a 98.8% customer retention rate.

Pricing Model

LST's pricing followed the standard software licensing model, in which the company charged upfront license and implementation fees along with annual maintenance, hosting, and support fees. An important aspect of the pricing model was that license and hosting fees were based on the number of customer records rather than number of customer loans. Banks would typically enter all of their customer loans, past and present, into the LST system for auditing and record-keeping purposes. Therefore, fees were based on both a bank's current and non-current loan customers and would not decrease when a current customer paid off their loan (thus insulating LST from a decline in new loan activity and loan defaults).

Technology Use in Banking

Spending on information technology in North American banks grew just 4% in 2007 and growth was projected to remain at this pace through 2009. However, many experts believed that spending on loan origination systems would increase more significantly due to the need for efficiency, compliance, and reporting. The largest increases in technology spending were expected to occur at mid-sized banks (Bruno-Britz, Crosman, and O'Donnell, 2008). In SP Equity's own survey of 72 banks in the $50 million to $10 billion range, 36% reported using Microsoft Excel for loan analysis rather than a loan origination

system. An additional 25% were using software for only one piece of the loan process rather than an overall application that tied lending departments together and functioned as a system of record.

Competition

There was one main competitor for LST, Cady Technologies, which was estimated to have revenues between $30-50 million. This company primarily served larger banks and maintained 35 of the largest 150 banks as customers. Like LST, Cady offered an enterprise level system that integrated lending departments within a lending institution. The company had not yet fully converted its legacy system to On-Demand, but this migration was likely to occur in the near future. Most of the other firms in loan origination software competitive space provided boutique regional-based point solutions that were at a disadvantage because of their lack of integration and record-keeping abilities. In addition, they were generally undercapitalized, family owned, and regionally-based.

Company Prospects

Steve believed that a couple of key focal points could significantly increase the company's level of success. First, while the current management team had deep industry knowledge, the sales and marketing arms of the company lacked focus and sophistication. Sales productivity in 2007 was at 50% with no quotas, no formal monitoring system, and varied sales commissions and bonuses; Steve's experience led him to believe that these productivity levels should be 80-90%. Second, Steve believed there was an opportunity to migrate the current license pricing model to a subscription-based model and increase recurring revenue from 42% to nearly 80% of total revenue in five years. While this would decrease revenue and EBITDA in the short term, it would lead to higher revenues, higher EBITDA, and a higher EBITDA multiple in the long-run.

THE DEAL

During negotiations, it became clear that Benson was mainly concerned with two aspects: leaving his "baby" in good hands and getting his $20 million. The buyer/seller chemistry was important to him, and he wanted to find someone who would continue to invest in the company rather than a buyer who would absorb the software into an existing corporate structure. He also wanted the business to remain in the same small town, but Steve did not make any promises regarding this aspect: the company was currently located in a renovated A&W restaurant in a town of 5,000 people, and Steve thought a move would be necessary to establish legitimacy.

Steve had several requirements in order to go through with the deal. First, Benson would have to sign a non-compete agreement at the closing and would not have any ongoing management responsibility. Second, Steve would only sign a one-year lease to stay in the current location. Third, the acquisition would be an asset purchase to take advantage of goodwill amortization that would amount to over $1.4 million per year; also, since it was an asset purchase, Steve insisted that all of the employees accept employment offers with the new company. Fourth, to provide a high upside to investors, Steve demanded that Benson sell a minimum of ninety-percent ownership interest. Finally, Steve required that Benson leave ten percent of the purchase price in escrow for eighteen months.

FINANCING THE ACQUISITION

Steve decided to leverage the purchase with approximately 45% debt and 55% equity. Additionally, he would seek a $1 million bank line of credit to provide the company with cash for working capital. The purchase price was agreed to be $20.16 million; this translated into a $9.2 million long-term loan to be backed by company assets and $10.96 million in investor equity. The bank loan had a five-year term, with a minimum $800,000 payment each year ($200,000 at the end of each quarter). The interest rates on both the term loan and revolving line were tied to the LIBOR rate and would be

approximately 6% per year. Based on Steve's financial projections, the company would be able to service the debt with a cash cushion (see Exhibit 6 for projected EBITDA and cash flow).

For the equity portion, Steve would invest an additional $100,000 of his own money, Benson would keep 7% equity (approximately $767,000), and investors in SP Equity committed to the remainder. Steve would earn 10% equity for completing the acquisition and up to another 10% for meeting performance goals; this would leave him with a total of 21% ownership (including his $30,000 investment at the search stage and $100,000 investment at acquisition) if the performance goals were met. Five percent of shares were reserved for employee options, and the remaining ownership would be split between Stage 1 and Stage 2 investors. The deal was structured so that equity investors would receive the amount of their investment first, and any "profits" above this would be distributed based on the above ownership percentages.

THE UNSETTLING NEWS

Earlier in the due diligence process, Steve had inquired about the percentage of revenue growth that had come from new customers as opposed to existing ones, and Benson had shrugged off the question. A few weeks later, Steve insisted on this information and Benson responded, "Our system doesn't have that data." Skeptical, Steve spent the next two days focused on pulling this information from the system, and when he finally did he was shocked.

The company had introduced its web-based system in 2001 and had acquired 332 web-based customers over the past six years. However, only thirty of these customers were new; the rest had converted from the Windows-based system. Even worse, Steve estimated that only fifty more Windows customers might convert, so he could not continue to grow the business in this manner. Steve had assumed if he took over that, at a minimum, he could expect to achieve the same growth rate LST had realized over the past few years. But the growth would have to come from new customers, and if LST only acquired thirty new customers in six years, how could he expect the growth that he projected? And, if Benson was not willing to divulge this information, what other unpleasant surprises were waiting for him if he went ahead with the acquisition?

Steve took a deep breath and wondered if this was the end. He was running out of time and money, and if this acquisition fell through his funds might completely dry up before he found a company to buy. Yet, he could not try to convince his investors to stay in the deal if he was not sure about it. He decided to head for bed, though he was certain he would not sleep.

EXHIBIT 1
STEVE PEPPERMAN'S RESUME

Professional Employment
- Software Systems OTC, Inc., Mpls, MN. April 2003-Oct 2006

Vice President, Mergers and Acquisitions, March 2005-Oct 2006
Global Vice President/GM – Demand Stream Division, April 2003-Feb 2005
- SP Venture Partners, Mpls, MN, Oct 2001-March 2003

Founder/Managing Partner
- Epicor Software, Irvine, CA, Sept 1996-April 2001

Vice-President/GM – Impresa Division, Sept 1996-April 2001
Vice-President/GM – Vista Division, Feb 2000-April 2001
- Data Systems & Management, St. Paul, MN, Aug 1994-Aug 1996

Vice President, Professional Services
- SP Technologies, Mpls, MN, July 1992-July1994

CEO/Founder
Education: B.A., Computer Science, University of Minnesota-Duluth

EXHIBIT 2
RECENT ACQUISITION MULTIPLES FOR SAAS FIRMS

Date	Company	Acquirer	Transaction Value ($mm)	EBITDA ($mm)	Multiple
2/08	Capital Stream	HCL Technologies	$40.0	$1.1	36.4
2/08	Genesys Conferencing	West	$284.5	$32.7	8.7
2/08	QM Technologies	Computershare	$124.0	$13.9	8.9
1/08	Manatron	Thoma Cressey Bravo	$70.1	$4.5	15.6
12/07	Northgate Information	KKR	$1,180	$92.9	12.7
12/07	NSB Retail	Epicor	$322.0	$19.8	16.3
12/07	Nuvo Network Mgt	Versata	$17.6	$0.5	35.2
9/07	iEmployee	Asure Software	$10.7	$1.6	6.7
8/07	Accretive Commerce	GSI Commerce	$97.5	$4.9	19.9
7/07	H-G Holdings	Concur Technologies	$179.3	$10.7	16.7
3/07	Computer Software Grp	HgCapital	$193.0	$6.5	29.7
3/07	WebEx	Cisco	$2,788.5	$112.5	24.8
1/06	Outtask	Concur	$79.2	$2.3	34.4

Median	16.7
Average	20.5
High	36.4
Low	6.7

Source: Pagemill Partners

EXHIBIT 3
EXCERPTS FROM SP EQUITY PRIVATE PLACEMENT MEMORANDUM

Executive Summary

SP Equity, LLC is a private equity search fund formed to exploit an opportunity in the software industry. Over the past 18 months, through research and practice, SP Equity has uncovered a lucrative opportunity for investors. The opportunity revolves around a dilemma regarding a software technology trend combined with an underserved acquisition/divestiture buyout market window.

The Software Dilemma and Technology Trend. Thousands of software companies today are facing a difficult dilemma regarding their legacy client server systems. Industry indicators show legacy-based software companies are finding it difficult to compete against an emerging trend toward On-Demand applications. The On-Demand software movement is growing at a brisk pace via key success factors such as a more efficient deployment model and far superior economic model. On-Demand technology is best described as "Software technology… that is rented on a perpetual basis, deployed on a hosted platform, and Web centric." Industry giants SAP, Microsoft, and Oracle, along with leading analysts have all made recent proclamations and investments regarding the coming On-Demand shift. Today's legacy software company faces a significant dilemma: either invest in On-Demand technology or continue to lose market share and significant valuation.

The Buyout Market Window. Although the buyout market is hot, SP has discovered a window where the buyout market is not active. Software companies below $20M in revenue fall below the radar of these firms. After 18 months of research and practice, SP found that a majority of the deals above $20M had one to two buyout firms or corporations represented. Companies for sale with below $20M in revenues had small investment firms or private investors at the table. This window below $20M presents an opportunity to purchase a legacy software company at an affordable multiple.

Opportunity Summary. SP believes the combination of the On-Demand trend and an acquisition window below the radar presents a lucrative opportunity. In summary, SP will:

- Acquire a legacy software firm with $5M to $15M in revenue and 10%-15% EBITDA

- Purchase at industry or lower multiples (4x to 6x EBITDA)
- Invest in an On-Demand technology platform
- Grow the business over 3-5 years above $20M in revenue and 20% EBITDA
- Sell the company at On-Demand industry multiples of 8x to 12x EBITDA
- Provide an investor IRR between 30% and 60%.

Financing Stages

Stage 1 – Search Financing. SP is raising $360,000 through the sale of twelve investment units priced at $30,000 each. This initial pool of capital is intended to sustain a search for up to 18 months. All funds invested in SP will be converted to securities in the acquired company and stepped up by 50%. The management expects to earn a 20% share of the total equity: 5% upon completion of an acquisition, another 5% that will vest monthly over 3 years, and the remaining 10% will be tied to performance objectives. Management (Mr. Pepperman) will purchase the first investment unit ($30k) to show investors his financial commitment to the opportunity.

Stage 2 – Acquisition Financing. SP intends to finance the acquisition of the target company through a combination of equity and debt. Investor capital is expected to represent approximately 30%-60% of the company's total capitalization.

Investor Return Model

Example: Software firm with $10 million in revenue and 15% EBITDA, purchased for 6x EBITDA ($9 million). Using 60% debt-to-equity, acquisition financing would be $5.4 million debt and $3.6 million equity. At 8% interest, annual interest payments would be $432,000.

EBITDA (w/o growth)	$1,500,000
Less Annual Interest	$432,000
Annual Cash Remaining for Debt Retirement	$1,068,000

The debt would be retired in 5 years, leaving all funds from sale to be distributed among investors. Search fund investors would own approximately 10% of the firm. Stage 2 investors would own approximately 65% equity. Management would own 20% and employees 5%.

Potential Returns in Optimistic, Base Case, and Pessimistic Scenarios:

	Optimistic	Base Case	Pessimistic
Revenue Gain per Year	15%	9%	3%
EBITDA Gain per Year	1.5%	1.5%	1.5%
Exit EBITDA Multiple	10x	8x	6x
Year 5 EBITDA	$4,525,554	$3,461,904	$2,608,367
Exit Value	$45,255,540	$27,695,232	$15,650,202
Stage 1 Cash Out	$4,525,554	$2,769,523	$1,565,020
Stage 1 IRR (over 6 years)	52%	41%	28%
Stage 2 Cash Out	$29,481,101	$18,001,901	$10,172,631
Stage 2 IRR (over 5 years)	52%	38%	23%

EXHIBIT 4
LST HISTORICAL INCOME STATEMENTS (IN THOUSANDS)

	2003	2004	2005	2006	2007
Revenues	3,184	3,966	3,373	3,796	6,614
Recurring Revenue	1,109	1,526	1,781	2,164	2,953
% Recurring	34.8%	38.5%	52.8%	57.0%	44.6%
Total COGS	190	310	476	525	692
Total Operating Expenses	1,515	1,815	1,601	1,698	2,547
EBITDA	1,478	1,841	1,296	1,573	3,375
EBITDA %	46.4%	46.4%	38.4%	41.4%	51.0%
Depreciation	92	95	31	33	0
Income Before Tax	1,386	1,746	1,265	1,540	3,375

Source: Company Documents

EXHIBIT 5
CUSTOMER PENETRATION BY U.S. REGION (BANKS AND CREDIT UNIONS)

	All Banks/Credit Unions		**LST Current Customers**			
Region	Number of Institutions	Assets (in millions)	Number of Institutions	Assets (in millions)	Annual Recurring Revenue	Penetration (% of Institutions)
Central	2,382	$1,282,109	148	$85,230	$599,225	6.2%
Northeast	1,373	$2,443,945	1	$400,000	$1,107,920	0.1%
Southeast	2,280	$3,753,609	17	$119,693	$90,682	0.7%
West	1,055	$2,851,314	7	$88,298	$47,746	0.7%
Midwest	3,331	$3,196,154	150	$310,164	$722,550	4.5%
Total	10,421	$13,527,131	323	$1,024,692	$2,568,123	3.1%

West: CA, WA, OR, ID, NV, UT, AZ, AK, HI
Central: MT, WY, CO, NM, ND, SD, NB, KS, OK, TX
Midwest: MN, IA, WI, IL, MO, IN, OH, MI, WV
Southeast: KY, TN, MS, AR, LA, AL, GA, FL, SC, NC, VA
Northeast: PA, MD, DC, DE, NJ, CT, RI, NY, VT, NH, ME, MA

Sources: FDIC Statistics on Depository Institutions (www.fdic.gov), Company Documents

EXHIBIT 6
PROJECTED EBITDA AND CASH FLOW

Conservative Scenario ($000's):

	Year 1	Year 2	Year 3	Year 4	Year 5
# of New Licenses Sold	109	109	109	109	109
% Sold on Subscription	50%	50%	50%	50%	50%
Total Revenue	5,657	6,642	7,644	8,617	9,560
% Recurring	65%	70%	74%	77%	79%
Total COGS	782	870	958	1,046	1,134
Op. Expenses	3,102	3,298	3,496	3,694	3,895
EBITDA	1,773	2,474	3,190	3,877	4,531
EBITDA %	31.3%	37.2%	41.7%	45.0%	47.4%
Less:					
Taxes	(108)	242	610	976	1313
Capital Expenditures	160	160	160	160	160
Working Capital Increase	(566)	(479)	(481)	(482)	(466)
Interest Expense	522	418	293	138	18
Cash Flow to Service Debt	1,765	2,132	2,609	3,085	3,507

Optimistic Scenario ($000's):

	Year 1	Year 2	Year 3	Year 4	Year 5
# of New Licenses Sold	125	144	166	190	219
% Sold on Subscription	50%	50%	50%	50%	50%
Total Revenue	6,027	7,594	9,419	11,484	13,828
% Recurring	63%	66%	69%	71%	72%
Total COGS	795	911	1,045	1,198	1,375
Op. Expenses	3,265	3,649	4,062	4,510	4,995
EBITDA	1,967	3,034	4,312	5,776	7,458
EBITDA %	32.6%	40.0%	45.8%	50.3%	53.9%
Less:					
Taxes	(19)	501	1,134	1,854	2,625
Capital Expenditures	160	160	160	160	160
Working Capital Increase	(642)	(639)	(738)	(839)	(957)
Interest Expense	520	405	250	87	27
Cash Flow to Service Debt	1,948	2,608	3,507	4,514	5,602

Source: Company Documents

TEACHING NOTE

Purpose

The main purpose of this case study is to illustrate financial concepts surrounding the search for and acquisition of a company, including financing stages, returns to investors in different stages, how value is created through the layering of debt and equity financing, and the importance of valuation multiples. Further, most entrepreneurship students (even those at the MBA level) have not considered business acquisition as a route to entrepreneurship and this case exposes them to important aspects of this path. These include the search fund process, executing a successful search and acquisition, assessing an acquisition target, deal terms, and the importance of due diligence. This case is designed to be used in undergraduate or graduate courses on entrepreneurial finance when covering the topic of deal structure. Case discussion will consume an entire 75 to 90 minute class period.

Case Questions

1. Evaluate Steve's background. Is he ready to purchase/manage a business like LST?
2. What are investors in the search fund betting on? How is Steve proposing to create value?
3. Evaluate Steve's search process. What key lessons can you take away from his search?
4. Is LST an attractive company to purchase? Why or why not?
5. How is the deal for LST being structured? How does this create value?
6. Calculate projected returns in the conservative and optimistic scenarios to: a) investors in the search fund, b) investors in the current deal, and c) Steve.
7. Did the seller have an ethical and/or legal obligation to reveal the information related to LST's growth that Steve asked for? Should Steve go ahead with the acquisition?

Classroom Strategy

An effective strategy for discussion of this case is to start by asking the class for a show of hands on who thinks Steve should purchase LST. The class will likely be divided on this and you can ask one or two students on each side why they have taken that position. This will pull out several of the key points in the case. Then, you can facilitate a detailed discussion by asking each case question to the class and putting key points on the whiteboard. The questions are designed to take students through the process from start to finish (from "Is Steve ready?" to "Should he go through with the deal?"). You can then finish by telling the class what happened.

1. Evaluate Steve's background (5 minutes)
   a) Extensive resume of management experience with the software industry: He has been in the software industry for 25 years; started, grew, and sold his own firm; has a history of successfully grooming businesses for sale.
   b) Experience in software acquisitions and sales: Led M&A Worldwide for Software Systems OTC; performed due diligence on 77 companies and closed two deals; gave him experience to identify attractive candidates and quickly weed out unattractive ones; Gave him understanding of typical purchase multiples (important because this is really a numbers game)
   c) However, Steve has never been in this position, where everything is on his shoulders. If the business fails, he will lose a lot of his own money along with that of family, friends, and other investors (the pressure in this type of a situation is very different than in working for someone else).

2. What are investors in the search fund betting on? (10 minutes)

They are mainly betting on Steve's ability to find and acquire an attractive company at an attractive price. If Steve can do this, even modest revenue growth and margin improvement will lead to attractive returns for investors. Based on Steve's background, his ability to manage and grow a business that is acquired appears to be low-risk. The main risk for the search fund investors is that Steve will not be able to find a company to buy.

This is a good opportunity to introduce the "numbers game" mentioned above (see Exhibit 3 in the case). You can show students the power of debt leverage by pointing out in Steve's example that even if there is no change in the value of the business post-acquisition that the equity holders would gain an additional $5.4 million in value after the debt is paid off. Advanced students might point out that if there was no debt then these debt cash flows would be available for investors and therefore there is not much difference. However, the key is that equity investors are only risking $3.6 million upfront rather than $9 million, and the $5.4 million in debt would be repaid at approximately 6% interest, far less than the 30-50% return required by equity investors. Note that even in Steve's pessimistic scenario that search fund investors would receive four to five times return on their investment.

3. Evaluate Steve's search process. (10 minutes)

To help students understand the importance of a targeted acquisition search strategy, it is useful to start by asking a few questions around what would happen if someone who wanted to buy a business did not have one. This will lead to a brief discussion of where would this person start to look, what kind of business would he or she end up buying (if any), how long would it take, how effective would he or she be using resources, etc. You can then compare it to having a strategy for a business. Students will likely catch on right away but this is an important point to make considering most of the students will not have given much thought to buying a business or how they would go about doing so.

Steve's search strategy was to narrow down his targets both geographically and by software niche (compare this to a firm's geographic and demographic customer strategy and what this allows a firm to do). This gave him concrete targets in seven large cities. Steve then attempted to get "warm leads" to these targets, which would be helpful not only getting in the door but also identifying which business owners might be ready to sell. An important point to make with students here is that *every business is for sale*; it is a matter of the right party contacting them, at the right time, and offering the right price. However, some may be more ready to sell than others; it makes sense to target these first.

4. Does the purchase of LST represent an attractive opportunity? (20 minutes)

A useful framework to analyze opportunities revolves around three dimensions. Useful readings that expand on these dimensions are Bhide (1996) and Magretta (2002).
   a) Personal
      * Steve's background is an excellent fit, as shown in Question 1.
      * Steve appears to be up for the challenge of growing and selling a business for a significant return, as evidenced by what he has accomplished with SP Equity so far.
      * One question to ask is impact on family (moving to a new city where Steve will be consumed with the new business); they need to be on board.
   b) Market
      * The product provides value to banks, as evidenced by the low attrition rate.
      * The market is large (with over 9500 institutions in their target market) and there are few alternative LOS systems on the market. 30-40% of banks between $50 million and $10 billion used Microsoft Excel for loan analysis.

- There is a significant opportunity to expand beyond the Midwest.
- The company has had success with little marketing sophistication and low sales productivity. Steve's experience can add significant value here.
- The company had recently introduced products aimed at other vertical markets that were larger than agriculture and provide an opportunity to upsell current customers.
- Risks: Large % of recurring revenue tied to one customer and growth has come from existing customers. Can Steve continue to grow the firm?

c) Financial
- The company was already on a web platform so no significant time/capital investment would be needed for this aspect; this makes the company scalable right away.
- There was an opportunity to migrate more customers to a subscription-based pricing model, leading to higher revenues and a higher exit multiple in the long term. The pricing model was also robust, as it was based on total loans past and present.
- The purchase price was 6.5 times EBITDA, which was on the low end for firms in the industry (see Exhibit 2). However, some caution should be taken here, as the multiple is closer to 10 when using the average EBITDA for the previous three years. Steve needs to determine if 2007 is a representative year moving forward.
- Low risk in terms of breakeven to cover debt obligation (using Year 1 conservative scenario and leaving tax impact at -$108,000 for simplicity):
    - Need EBITDA of $808k to cover debt (from Exhibit 9 cash flow)
    - Contribution Margin = 1 – (COGS/Sales) = 1 – (782/5657) = 86.1%
    - Breakeven EBITDA + Op Expenses = 808 + 3102 = 3,910
    - Breakeven Sales = 3910/.861 = $4,537
    - Safety Margin = (Projected – Breakeven)/Projected = (5657-4537)/4537 = 19.7% (can still make loan payment if revenues are 20% below projected)

- But there is financial risk: Steve is investing an additional $100,000 of his own money, plus $10 million from investors, some of whom are family and friends.

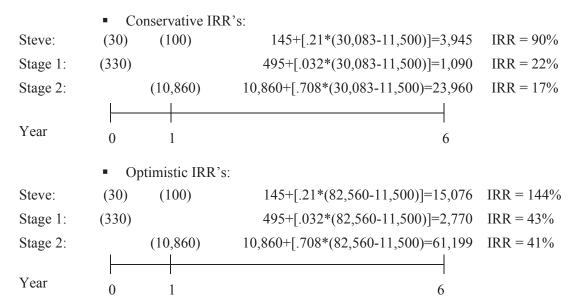5. How does the deal create value? (30 minutes)

a) Layers of financing
If this has not been covered in class, it is useful to provide an overview of layering financing, and to emphasize that an entrepreneur's job with financing is to start with the cheapest sources of financing first and use more expensive sources as necessary and appropriate. This involves determining how much collateral there is to secure debt and how much debt can be serviced, then financing as much as possible with senior debt and covering the rest with subordinated debt and equity (Stevenson and Roberts, 2002).

b) Structure of the deal
- $9.2 million debt at 6% interest, minimum $800,000 annual payment
    - A question that can be raised here is whether Steve could/should be structuring the deal with more debt. In year one, projected cash flows in the conservative scenario show a cash cushion of almost $1 million above the required debt payment of $800,000 (in subsequent years, the cushion is even greater).
- $10.96 million in equity

- - - Plus $360k from search fund with 50% step-up, total equity = $11.5 million
  - - Steve received 20% for acquisition and performance, 5% reserved for options
  - - Remaining 75% ownership (assuming Steve hits performance goals):
    - - Steve: ($45k + $100k)/$11.5 million x 75% = 1.0%
    - - Other Stage 1 Investors: $495k/$11.5 million x 75% = 3.2%
    - - Other Stage 2 Investors: $10.96/$11.5 x 75% = 70.8%
- c) Returns for Search Fund Investors, Acquisition Investors, and Steve
  - Assume the company is sold after five years at 6x EBITDA in the conservative scenario and 10x EBITDA in the optimistic scenario (from Exhibit 3)
  - Assume that even in the conservative scenario Steve meets the performance goals and attains 21.0% ownership (this presents the "worst-case" return scenario for investors)

	Conservative	Optimistic
Accumulated Cash (Exh. 9)	$13,097	$18,180
Less: Loan Principal and Revolver	($10,200)	($10,200)
Plus: Year 5 Exit Value	$27,186	$74,580
Total Cash for Distribution	$30,083	$82,560

- - Conservative IRR's:

Steve: (30)   (100) $145+[.21*(30,083-11,500)]=3,945   IRR = 90%

Stage 1:   (330)   495+[.032*(30,083-11,500)]=1,090   IRR = 22%

Stage 2:   (10,860)   10,860+[.708*(30,083-11,500)=23,960   IRR = 17%

Year   0   1   6

- - Optimistic IRR's:

Steve: (30)   (100)   145+[.21*(82,560-11,500)]=15,076   IRR = 144%

Stage 1:   (330)   495+[.032*(82,560-11,500)]=2,770   IRR = 43%

Stage 2:   (10,860)   10,860+[.708*(82,560-11,500)=61,199   IRR = 41%

Year   0   1   6

You can also emphasize here why debt makes the deal so attractive by showing a "what if" scenario with the entire purchase financed through equity. In this case, to receive a 30% IRR on their investment, Stage 2 investors would need $20.16 x 1.30^5 = $74.9 million in return.

6. Was the seller obligated to provide Steve with the information Steve asked for? What should Steve do? (5 minutes)

Questions to ask from an ethical perspective would be whether there was a misunderstanding of what Steve was asking for or why it was important (although the information given in the case does not support this) and whether not providing the information might cause Steve any harm (the answer to this is "yes"; therefore you might argue that Steve had a right to know). Most students will agree that this appears unethical.

However, most students will argue that legally it is an issue of "buyer beware." You can then point to what the seller's obligations are in terms of full disclosure, which are very clear under securities laws: a seller can neither misinform a buyer of securities nor leave out relevant information about the firm that may adversely impact the buyer's purchase decision. If Steve purchased LST without knowing this information and the company performed poorly as a result, Steve could pursue a lawsuit against Bob Benson (although this is far from an ideal situation).

Steve essentially has three options. He can either: 1) Walk away from the deal, 2) Try to negotiate the price down, or 3) Go ahead with the deal as is. His main consideration is how confident he is in his projections despite the new information.

7. What happened? (5 minutes)
    a) The next day, all of Steve's key investors backed out when they heard the news. However, Steve believed that he could implement the same sales process that he had been successful with at previous companies and that there was still tremendous upside. Steve pulled his car over to the side of the highway to take a call from his largest investor and was able to convince him to re-commit to the deal. The other investors then followed. Steve contemplated negotiating the price down, but was told by a manager of LST that Benson would walk away if he did. Benson could still demonstrate three years of sales growth and knew he would attract buyers at the price he was asking.
    b) Key events in first 16 months of ownership:

- Changed out 56% of the staff to bring in more experience. The business had a number of "recreational employees in a lifestyle business model."
- Revamped the name, image, website, and message. Hired a marketing firm out of Atlanta with 3 former Oracle, D&B software executives to reimage the company.
- Overhauled marketing, lead generation and sales methodology.
- Moved the business to a large city in another state and invested $400k in the new facility. Received over $1 million in state tax break incentives to move the company.
    c) Key accomplishments in first 16 months of ownership:

- Obtained 148 new customers for a total of 480 web-based customers.
- Began getting calls from equity funds looking to buy the business every 2-3 weeks.
- Tripled the price of the product and invested another $1.5 million into R&D.
- Competitors' sales reps began calling to join LST because "they were tired of losing to LST in deals".

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