

VIEWPOINT

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SOX COMPLIANT: TO BE OR NOT TO BE, THAT IS THE QUESTION

By Elliot Williams

The Sarbanes-Oxley Act of 2002 (SOX) clearly is having a profound impact on the way corporate America is governed and managed. Developed with good intent – to elevate governance standards in the wake of flawed practices at public companies such as Enron, WorldCom, and Tyco – SOX has been assailed for going too far. That's been especially true for small public companies and those considering IPOs. The Act's section 404 has been particularly notorious, requiring independent audits, written sign-off on the validity of financial results by top officers, and much more.

But specifically how does SOX affect private middle-market businesses? Are there things management at early and mid-stage companies should do now to avoid potential SOX problems when the time to exit eventually moves into sight? And does SOX have the potential to impact your ultimate choice of an exit strategy?

To get answers to these important questions, Mirus Capital Advisors polled attorneys who are involved in all facets of M&A transactions. (The survey went to a select group of senior attorneys and partners at top Boston-area law firms, most of them working with public and private companies. Those responses were augmented with in-depth phone interviews.) We also spoke to senior deal makers at two leading private equity firms, Alan C. Botsford, a partner at Parthenon Capital, and Thomas S. Roberts, managing partner at Summit Partners, to get their perspective on SOX and its impact on private mid-market firms.

SOX'S IMPACT ON EXIT STRATEGIES

Our key conclusion: owners and managers of private middle-market businesses need to become savvy about SOX, and quickly – even if you have no intention of going public and even if a sale isn't in the immediate future. While you don't need to be SOX compliant right this minute, you do need to put good controls and reporting systems in place because, without them, the path to compliance is not clear.

WHY THIS MATTERS:

- *Understanding the potential impact of SOX on future exit strategies is critical for the leaders of middle-market private firms, even those that are not yet near the exit point.*
- *Moving towards SOX compliance increases your exit options. So taking steps to become compliant makes sense even if no sale or IPO is immediately planned.*

"It's important to realize that the closer a company is to SOX compliance, the greater its range of exit options," said Roberts of Summit Partners. "We advise our companies to be aware of what it means to be SOX compliant and as a private company to make conscious decisions about where to apply resources to knowingly either become or not become compliant."

Without a clear path to compliance, the option of doing an IPO is completely off the table. And in a market where private equity is far more common as an exit scenario than IPOs, it's important to realize that private equity firms might either walk away from or, at the very least, drop the valuation.

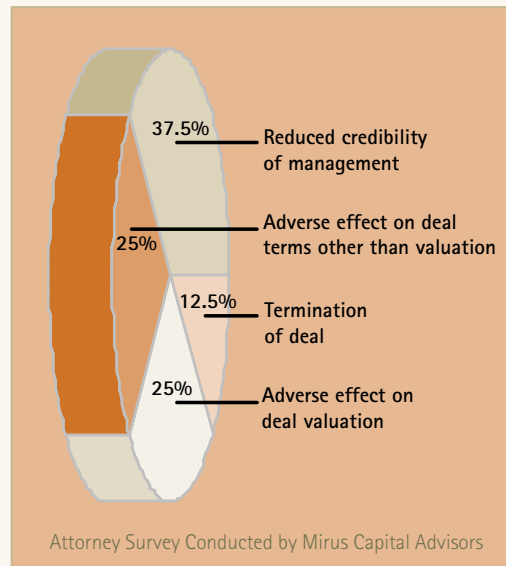
In the case of a strategic purchaser, if that buyer is a private company, its management still must consider an acquisition's potential for becoming SOX compliant because they may ultimately become a candidate for an IPO or be acquired by a public company. On the other hand, if the strategic buyer is already a public company, its management will be interested in how a potential acquisition fits into their SOX compliance.

"Small public companies have been finding SOX compliance costs to be disproportionately burdensome on them because of the way that these costs scale," Alan Botsford told us. The same naturally holds true for small private companies that feel they need to move toward SOX compliance.

This cost factor may be why the Mirus attorney poll found that there is little apparent activity when it comes to private companies pursuing SOX compliance – or SOX readiness at least – in preparation for a sale of the business. Yet more than a quarter of the attorneys said the Sarbanes-Oxley Act affects between 50 percent and 75 percent of M&A deals that involve private companies. A deal may not be imminent, but buyers are looking for liabilities by poring over financial and governance histories – not just the target's recent statements.

Private-company managers who think that SOX is simply a bump in the road should think again, according to our study. Even though a minority of the attorneys we polled thought that public

WHAT IS THE MOST SIGNIFICANT CONSEQUENCE YOU'VE SEEN OF DISCOVERING SARBANES-OXLEY NON-COMPLIANCE DURING AN ACQUISITION PROCESS?



companies are less inclined to pursue private acquisitions because of the rigors of Sarbanes-Oxley compliance, nearly two-thirds said that SOX has made public buyers more risk-averse when considering private targets.

"COMPLIANT" OR "READY TO COMPLY?"

Fully 40 percent of the attorneys polled by Mirus confirmed that publicly owned acquirers now emphasize assessments of private targets' ability and readiness to comply with Sarbanes-Oxley provisions. And what if a buyer's due diligence discovers that the target isn't SOX-compliant? What negative effects might sellers experience? Nearly 40 percent of respondents replied that

the sellers' management team would be seen to be less credible; another 25 percent pointed to an "adverse effect" on the deal's valuation; and 12 percent mentioned the specter of the deal being terminated altogether. (See chart.)

Even so, the costs of full SOX compliance make it impractical for most private mid-market companies. "It makes no sense for them to actually be SOX-compliant," said one attorney. "But a SOX-ready company will have good internal controls and procedures already in place and proper documentation ahead of a sale, making due diligence much more efficient, manageable, and straightforward."

Summit's Tom Roberts believes SOX readiness, by itself, does not improve the marketability of a company, but it does help alleviate the compliance-related friction inherent in today's deal environment. "If you're thinking of being acquired by a public company, being near SOX compliance is valuable, but unless you have substantial compliance issues, SOX is unlikely to blow up your deal," he said.

Alan Botsford said a lack of SOX readiness won't make a company less marketable to private equity firms. "Most private equity firms believe that unless there are serious underlying financial control issues, they can take the steps necessary to make a company SOX compliant over time," he said.

SOX DEMANDS LONG-TERM VS. SHORT-TERM THINKING

So what should private-company leaders be doing now to become smarter about SOX? Recommendations mentioned most often by the attorneys surveyed include these:

- Study the "good business practices" that SOX has brought to light;
- Focus on improving internal control activities and the internal financial processes (documentation is key);
- Implement strict policies regarding the auditor's role and capacity;
- Revamp the corporate code of ethics;
- Define the role of an independent board;
- Develop a formal whistle-blowing policy.

"Many of the internal control and reporting mechanisms of SOX can take time to implement, and changes in relationships with people such as board members or auditors can take a long time to ramp up," said Botsford. For this reason, it would be a mistake to delay ramping up for SOX readiness or compliance until a sale or IPO is in the immediate offing.

The information we garnered in our attorney survey and in our discussions with prominent dealmakers sheds light on the road map for owners and managers who are thinking of selling the business. In the end, both Botsford and Roberts noted that SOX imposes a rigor to accounting, internal controls, governance and

other disciplines that is the hallmark of well-run companies.

According to Botsford, "If you strip out the very technical aspects of SOX compliance, the spirit behind most of the regulations is in practice really the same qualities that we have always looked for in a company."

"It's a good discipline," said Roberts. "You may not want to do it to the nth degree, but it's a good set of issues to think about as a private company."

Finally, here are two key thoughts to keep in mind:

- **Savvy entrepreneurs know that companies should be built with an exit strategy in mind, no matter how far down the road that strategy might be executed.** While SOX compliance may be a "nice to have" asset today, eventually it will become a "must have." So the best strategy is to put a plan in place now for gradually getting there.
- **The lives of many companies include unforeseen events that cause an earlier-than-expected exit.** These include the sale of a major competitor that totally alters the market dynamic, an unexpected call from a very motivated buyer, or a failure of the business plan that makes implementing an exit strategy sooner rather than later the only prudent choice. Any of these events could quickly push the need to be SOX compliant or at least SOX ready onto your front burner.

Elliot Williams is president of Mirus Capital Advisors, Inc. Mirus is a middle-market investment bank that specializes in advising companies in strategic mergers and acquisitions. By combining a proven process, industry and transactional expertise, creative thought, and personalized service, Mirus has completed hundreds of transactions for both public and private companies. Mirus is a registered broker-dealer and NASD/SIPC Member. For more information, visit www.merger.com.

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