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The Founder Quandary
By Avram Davis
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The founder of a target company needn't always have a role post close, but the decision to replace a founder is no simple matter.

When Windsong Allegiance Group acquired Joe Boxer Corp. in March 2001, the buyer was faced with a quandary that confronts all acquirers, whether strategic or financial in nature. Joe Boxer's founder, Nicholas Graham had leveraged his quirky sense of humor to build the company and its distinctive brand. The problem was that Joe Boxer was ill-equipped to handle the financial complexities of being a larger business. Ultimately, Windsong president Bill Sweedler assumed the chief executive role at Joe Boxer, while Graham took on a new title as the "chief underwear officer," a gimmicky, though appropriate title that allowed the company to build on Graham's strategic vision without being held up by his limitations.

In the middle market, the decision to replace the founder of a target company is rarely a simple matter. The essential relationships with the company's major customers often reside with the CEO and upper management, and are not easily transferred when new management takes over. Moreover, a founder's vision, like in the case of Joe Boxer, can be among the most valuable assets a company has. At the same time, the current managers may not have the skillset to build on that foundation. Moreover, in the case of strategic acquisitions, a former owner can sometimes create confusion and resistance to a buyer's best laid plans.

The first question that **Chris Sheeren**, a partner at **Huron Capital Partners**, asks is: does the founder want to stay with the company? "The CEO's personality can have a very strong stamp on the business, especially if the CEO is also the founder," he says. If the CEO doesn't want to stay on board, it can shape whether or not a deal even makes sense.

"Some of these customers have a 15- or 20-year relationships with the executive at the company," adds **Marc A. Goodman**, chief investment officer of **Fifth Street Finance Corp.**

Because of this, the default among buyers typically involves an attempt to keep the founder involved in the business.

John F. Storz, a corporate partner at **Brown Rudnick**, notes this isn't always the best decision. He notes, for instance, that the DIY approach of many mid-market entrepreneurs often slows long-term expansion. "The classic flaw for founders is that they have an innate ability to build a business to a certain level, but to bring the company to the next level requires a very different skillset and ability," he says.

When a target company's founder wants to stay on but buyers are uncertain of whether they are the right person for the next stage of growth, it is a challenging - albeit essential - subject to broach. Many buyers will try to entice the founder to stay involved in the company as a consultant, while a new chief runs the day-to-day operations of the business. This arrangement can temper the traditional conflict that often develops between the CEO and the new owners after the close of the transaction.

Other times, the best alternative is just a clean break. **John Pouschine**, managing director of **Pouschine Cook Capital Management** remembers one situation in which he had to cut loose the head of a portfolio company. He describes the executive as a military, type-A personality who had grown accustomed to making all of the decisions about the strategic direction of the business. This vision, however, was not shared by the investors. Without even having a replacement in mind, the firm removed the CEO. The board of directors, Pouschine remembers, "looked at me like had six eyes and seven ears." He is quick to note, however, that within the first six months after the chief was removed, the company's revenues increased by roughly 40% while Ebitda almost doubled.

Corporate buyers, meanwhile, generally prefer to ease out the management team of target companies that they acquire. The exception to this, says Brian Davis, managing director and head of McColl Partners' financial sponsors group, is when the buyer is launching a new product line that requires the intellectual capital of the target's management team. In these situations, the incentive structure is likely to be similar to that used by a private equity firm, and may involve stock options or other incentives to turn founders into a team player.

Most deal pros acknowledge that today the decision over what to do with the founder should be made early on. Davis adds that most buyers will have a pretty good idea of which direction to take during the management presentations. "That's really when you determine whether the management is value-added, or if they should just stay on for a transitional period," he says.

Pouschine adds there are many tools that are available to enable buyers to make quick decisions about whether a specific founder will be valuable to a company's next stage of growth. "When I was doing this 20 years ago, the assumption was that you kept the manager, and then over time worked to assess their skills." That type of approach is considered a luxury by today's standards, but many acquirers have a crop of HR and consulting firms at their disposal to help them make quick decisions.

The key for many is whether or not the founders want to be there and truly buy into the deal and the vision of the new owners. The use of earnouts or other incentives, meanwhile, isn't necessarily going to convince a founder who may be more interested in retirement. Pouschine notes that if they really want out of the business, long-term incentives will have little effect forcing them to stay enthusiastic.