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Exit Focus

Preparing the business for sale

Exit Focus Series
Part three of five

The third part of the series suggests tactics to consider as well as mistakes to avoid in helping to prepare for the sale of a private company.

Introduction

Continuing from the first two parts of the Exit Focus Series, *Making the decision to sell* and *Finding the right buyer*, the third installment, *Preparing the business for sale*, suggests tactics to consider as well as mistakes to avoid in helping to prepare for the sale of a private business.

The next installments will address:

- **Part Four: The deal process**
- **Part Five: Preparing for life after the deal**

Need to talk?
Whatever stage of transition your company is at, we can help you make the complex decisions that need to be made, understand the process and choose the right option to help you realize the value of your business and achieve your long-term vision.

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Executive summary

Getting both arms around the challenge

While no one-size-fits-all answer exists to help manage the challenge of simultaneously running a successful business and managing a sales process, careful preparation is vital.

Adjusting your thinking well in advance

In order to achieve a successful sale of a business, the planning process should begin well in advance. Be aware of the various internal and external factors that should be identified in the early stages of the process to optimize business value.

Issues in evaluating and valuing the business

It is imperative to understand a buyer's philosophy and attitude toward the value of a business. What does it mean to them and how can you align this outlook with the business and its emerging valuation?

Getting the house in order

One of the first steps in preparing for a sale is to assess your current business performance. Determine areas of your business that may need improvement and take corrective action to resolve any issues before engaging with potential buyers.

Building the best package

Know your business landscape; be prepared to provide concise and knowledgeable responses when prompted by a potential buyer, and have key information relating to the business available if and when requested.

Forming the team

Involve key individuals from your company in the divestiture process—they will provide valued input, gather necessary information relating to the business and interact with potential buyers.

Getting both arms around the challenge

One of the most significant challenges faced by a company and its owners is laying the groundwork for the successful sale of the business. Much of the difficulty lies in balancing two competing priorities, each of which demands careful attention. On one hand, the seller must commit significant effort to steer the process and receive the highest value it can in the transaction. But on the other hand, they must also ensure day-to-day operations remain sharp and focused. The ability to balance these two aspects is what makes the process more difficult.

When that balance suffers, transactions can falter on anything from failures of awareness to subtle tactical missteps.

There have been many potential transactions that have disintegrated, but not necessarily because of one big oversight. Instead, it is mostly because of a series of misjudgments in the complex sale preparations, and the allure of a high price that can cloud rational thoughts about the risks associated with closing the deal.

While no one-size-fits-all answer exists to help owners manage the challenge of simultaneously running a successful business and managing a sales process, careful preparation is vital.

Adjusting your thinking well in advance

The objective is to keep value high and avoid the deal fatigue that results from a drawn-out process.

In order to achieve a successful sale, to minimize the risk of a failed transaction and to optimize the value shareholders receive, owners should start their preparations early.

The preparation process begins by simply recognizing that divestiture is a natural part of the business life cycle. Success requires understanding that a sale is a process like any other. It builds from a constructive mind-set and extends through a series of disciplined steps.

Early preparation is required to optimize value. A host of external and internal factors must be anticipated, coordinated, and managed; and an approach to mitigate those that come up and aren't anticipated needs to be defined. Both market conditions and business conditions must be considered. Even after a strong year of profits and growth, if market conditions are deteriorating it may not be the optimal time to divest. Value is influenced by the market, by the situational influences of the principals in the transaction, and by the unique aspects of the particular business being sold. In any circumstance, deal value maximization will not be achieved without efficient information management and effective communications.

Awareness shifts to action when owners recognize that information must be used to set perceptions about the business that are both factually correct and strategically on target. The right information—interpreted and presented correctly and directed strategically—unlocks the basis for value and builds confidence in projected performance. A tone of controlled urgency must be maintained among the buyer's own people, stressing the options of the seller and the opportunity at hand for the buyer. All in all, the objective is to keep value high and avoid the deal fatigue that results from a drawn-out process. In addition, value cannot be maximized in a vacuum: a seller must understand the courting party's agenda, value drivers, and deal-making and deal-breaking issues. (See Private Company Exit Strategies: Finding the Right Buyer for a full discussion of these factors.)

Credibility and control

During the sale process, surprises can quickly derail buyer-seller momentum and deflate perceptions of worth. Once the decision is made to sell a company, management should begin planning for the process and preparing the company for sale. Self-review and ample preparation time enables the seller to maintain control and minimize disruption to ongoing operations. Effective planning and preparation also enable a seller to better anticipate, understand, and actively manage unforeseen events and keep the sale process on track.

Conflicting signals compromise credibility and effectiveness by creating confusion and doubt. Therefore, all players on the seller's team—both internal managers and external advisors—must pull in the same direction and reinforce the same messages.

To build relationships with suitors and avoid the risk of not closing, trust is critical. A seller should provide key factual information to a potential buyer that is appropriately positioned. Trust and momentum also depend on the seller's anticipating questions and preparing appropriate responses. A seller must paint a clear picture of market conditions and opportunity, and relate it to the company's projection. Further, a seller should articulate underlying assumptions and value drivers, and outline how these opportunities will be captured. Key concerns, potential deal breakers, and price adjustment issues should be pushed to the head of the process and addressed early to avoid problems later.

Finally, a seller must stand at the nexus throughout the process—keeping the company focused, creating the correct management incentives and support, managing the advisory corps, and navigating the course between running an effective business and steering it toward a successful sale.

Success in preparing a company for sale depends on 10 critical steps

Although there is not a one-size-fits-all program to ensure the process of selling of a company is flawless, there are a few vital steps that owners should take in the process. Following these steps, at a minimum, will allow for a smoother sale process, with fewer problems faced along the way.

1. Align organizational objectives
   Share one direction and one message
2. Develop a divestiture plan
   Address the tactical priorities early on, so that resources, funding, and timing all fall into place
3. Assemble a team of trusted advisors and deal specialists
   Complement company strengths with functional experts
4. Get financial results organized
   Highlight key financial metrics and management tools, and demonstrate their relevance
5. Develop sound financial projections, and back them up with a picture of strong potential
   Tell a credible, accurate and compelling story
6. Understand subjective value, and see the business through the eyes of a potential buyer
   View the business—and its value—from a buyer's perspective
7. Initiate a buyer identification and assessment process
   Understand the likely buyers and consider them in the planning
8. Evaluate potential structuring alternatives
   Identify various structuring options and related trade-offs
9. Revisit specific transaction objectives and priorities
   Review the company's changing goals—and refine their direction
10. Determine—and execute—a specific sale timeline
   Act with precision once the decision to proceed has been made

Issues in evaluating and valuing the business

Subjectivity: the picture beyond the numbers

It has been said that beauty lies in the eye of the beholder, and often, financial worth does as well. To a great degree, value depends on the buyer: strategic buyers are interested in the firm's operations, and financial buyers are focused on near-term returns. If a seller can better understand a buyer's philosophy and attitude toward value, they can begin to understand how this outlook applies to the attributes of the business and its emerging valuation. An external market perspective prepares owners to present the most credible and most compelling picture of future growth and profitability.

(For a full discussion of buyer categories, advantages, and disadvantages, see the previous installments in this series: *Private Company Exit Strategies: Finding the Right Buyer and Making the Decision to Sell*)

Who's doing the buying—and how that affects value and strategy

Strategic buyers often emerge from the same industry and seek a good fit with some aspect of the seller's business. When the synergies are significant, the strategic buyer may be willing to pay more. A seller will want to anticipate those synergies in order to capture an appropriate share of the potential value.

Financial buyers typically hunt for investment opportunities where they can use the benefit of significant financial leverage to improve returns, provide financial support for the business as it pays off debt and grows, and then exit their investment for a profit in the short to medium term. For these buyers, the most marketable businesses tend to be those with solid cash flows, strong management teams, growing markets, a defendable market position, and lower capital expenditure requirements. Typically, financial buyers are highly sophisticated in terms of deal structure and diligence and often are flexible on the industry. The willingness of the credit markets to extend loans to private equity and the terms of those loans dictate the strength of private equity buyers.

If the buyer is strategic, adoption of the right mind-set often means understanding the benefits and costs of integration, including the potential opportunities, inherent sales and distribution channel synergies, purchasing power increases, production and administrative efficiencies, working capital improvements, and more.

On the other hand, if the buyer is financial, the focus may be on the need for improvements in the financial reporting systems or opportunities that could be accelerated and captured by a new infusion of capital, such as add-on or tuck-in acquisitions or new product launches.

Valuation: getting down to the number

For the seller, all of this qualitative framing finally turns toward simple quantitative questions: What does my business translate to in dollars and cents? How can I even think about selling without knowing the worth beforehand? Should I get a valuation and ask buyers to pay based on that price?

Of course, the answers aren't as straightforward as the questions. Market valuation benchmarks can sometimes set false expectations on both the high and low sides. Setting appropriate expectations begins by understanding the concept of fair market value—the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the facts. At its simplest, a business is worth its discounted present value of future cash flows. That being said, some say valuation is as much an art as it is a science, and a number of variables go into a buyer's perception of value.

In addition to discounted cash flow analysis, major alternative valuation methodologies include comparisons to similar, recent transactions; the public market pricing of like companies; and the value that could potentially be derived in a leveraged buyout. However, all of these are heavily reliant on the assumptions applied.

Other variables figuring prominently in the overall picture of worth include the management team's depth and strength and diversity of customer relationships. Evaluations can also crystallize around the company's stage in its life cycle, comparable growth rates and pretax margins, overall opportunities and risks in the company's industry, and the current financing and mergers and acquisitions environments.

Value perceptions are further influenced by a company's historical and projected financial results, as well as anticipated future events—whether good or bad. Finally, psychological factors can also play a part, ranging from the sense of scarcity to the presence of rival bidders and the urgency of a seller's motivation.

Given the number of variables and the importance of information, valuation and financial due diligence should be viewed as complementary, interrelated, and iterative tasks. The valuation should provide context for financial due diligence and should guide management toward key focus points for due diligence. The results of due diligence should shape the final valuation and structure.

Considering financial valuations respond to the value different buyers ascribe to the business, sellers must be prepared for several iterations of valuation. Throughout the sales process, the seller must build strong and credible messages around quality of earnings and develop a dynamic due diligence process that best prepares it for buyers' possible skepticism, rigorous analyses, and intense negotiations.

Getting the house in order

Early preparation for sale begins with a presale checkup—referred to as ***sell-side due diligence****—followed by corrective actions.*

As thinking turns to action, owners can focus their considerations on the right time to sell— keeping two thoughts in mind:

- It is best to avoid letting events dictate when you must sell
- The best way to avoid dictation by events is to maintain readiness and agility if an excellent opportunity arises

The actual events triggering a sale can be a combination of market and personal conditions, such as a highly favorable offer or a generational change in the business. At the end of the day, owners should always regard the possibility of a sale as one of their alternatives and be prepared by making sure everything they do generates and creates shareholder value, whether they are selling or not.

Presale checkup

Early preparation for sale begins with a presale checkup—referred to as *sell-side due diligence*—followed by corrective actions. The checkup is a diagnostic overview undertaken a few years before the sale that pinpoints the areas to prepare for sale. For instance: Are information systems robust enough? How strong is the management team—and how capable is it of running the business without the owner? What's the status of company assets? What's the situation regarding relationships with customers, and what improvements can be made today that a new buyer will appreciate and want to pay a premium for?

Corrective actions

Corrective actions to take in the two- to three-year approach to a sale can run the gamut, including making sure audited financial statements are in hand; shoring up accounting systems; improving the quality of financial reporting; paying attention to contracts with customers, suppliers, and employees; and securing and/or protecting the rights to the company's intellectual property. Particular complexity, hidden opportunities, and risks surround human resources issues, tax considerations, and governance preparedness.

Human resources issues

People-related considerations have been a common reason for failed expectations during mergers and acquisitions. Issues range from the talents of the executive team and how they fit into a new owner's plans to the financial implications of compensation and benefits packages. Understanding these components and advanced planning can increase the odds of success.

Once the financial picture of human resources is understood, refinements can begin to anticipate potential buyers' concerns and address weak points. Planning should begin with an inventory of compensation and benefit programs, including financial implications. This includes variable and incentive compensation programs, severance terms, retirement and health and welfare plans, equity compensation programs, and any benefits or special arrangements for or with executives. The executive team is especially important not only in terms of its talent and the ability to retain key people through the deal, but also of the financial implications of severing or continuing the relationship.

Buyers will want to know about retention and severance terms, obligations to keep executives for certain time periods, payments to executives and employees triggered by the transaction, collective bargaining agreements, defined pension benefit plans and any other unfunded retirement obligations. The equation can grow more complex if business units are carved out and sold apart from the whole, when human resources and benefit costs allocated to these units may not reflect expected costs on a stand-alone basis.

Beyond this, owners need to assess how the total human resources picture and associated programs will affect different types of buyers throughout the transaction lifecycle. Planning varies by deal and industry: underfunded pension plans that will need large cash contributions in the short term may be priorities in one case, while the costs of settling existing equity compensation and stock options loom large in another—for, say, a fast-growth IT start-up.

By understanding the human resources environment early on, taking steps to properly communicate the historical and future costs and realigning elements that facilitate the deal, owners can significantly smooth the path to a sale.

Tax considerations

Owners should enter negotiations with an understanding of the tax consequences of a transaction.

While tax structuring grows from a seller's and a buyer's goals, from the legal form of business, and from evolving tax laws, the success of the approach depends on anticipating the transaction, establishing objectives, and evaluating the economic and tax risks. Given the many variables and potential outcomes, owners should enter negotiations with an understanding of the tax consequences of a transaction, including different implications of an asset or share-based transaction.

First, a seller should recognize buyers typically prefer asset-based transactions for an appreciated business, so that the assets will receive a fair market value basis for tax purposes that can be recovered through future depreciation and/or amortization deductions. Beyond that, tax approaches vary with the form of business, can often be complex, and require planning.

A seller generally prefers to sell the shares of a corporation rather than the assets of the company. Assuming the proceeds of disposition are consistent, a share sale generally results in greater after-tax proceeds for a vendor.

Additionally, a vendor may be able to utilize his/her capital gains exemption on a share sale. The use of a capital gain exemption may provide the vendor an exemption of up to $750,000 related to a capital gain realized on the disposition of qualified property. Eligible property includes shares of a qualfied small business corporation ("QSBC"). The capital gains exemption is only available to inviduals; corporations are not entitled to a capital gains exemption. There are stringent requirements to determine the eligibility of QSBC shares. Planning in advance of a share sale may facilitate the multiplication of the capital gains exemption.

The divergent positions of buyer and seller frequently lead to the need to negotiate the terms of sale to create a mutually beneficial transaction for both parties.

Governance preparedness

Another area that can be addressed early is governance readiness. Any private company contemplating acquisition by a public company or an initial public offering must take into account the demands of this corporate governance and financial disclosure law and prevent them from becoming obstacles to a smooth sale. At the same time, many actions taken for governance preparedness, if adjusted to the needs and scale of the company, can pay dividends in better business management.

Most importantly, embracing the rules can decrease the risks associated with closing the deal.

Governance readiness may also have a significant impact on valuation because buyers, investors and underwriters do not want to assume the added risks of non-compliance, nor the initial cost of compliance in terms of professional fees and lost productivity.

Owners can also benefit from these preparatory actions by (1) assessing their internal controls, governance policies, and systems and (2) taking steps to correct deficiencies and install better business operating processes in advance. These steps will not only pave the way for a smoother sale but also help make for a stronger, more competitive company with more-accurate information and greater management understanding.

Building the best package

Sell-side due diligence

Sell-side due diligence helps identify areas that have deal and value implications, and prepares and coaches management to appropriately address the issues with potential buyers. To answer key buyer questions, timely, concise and knowledgeable responses are necessary, and anything less can detract from value and the likelihood of success. Areas of focus typically include:

- Understanding the quality of historical earnings
- The components of both historical and projected business trends
- Key customer and supplier relationships
- Working capital and capital expenditure requirements
- Strength of the management team
- Potential synergies
- Technology and intellectual property issues.

Many of these areas can be addressed initially by a high-level management presentation or, occasionally, a Confidential Information Memorandum (provides a detailed description of the business, future opportunities, and historical and projected performance) to educate acquirers on the benefits of owning the business. Ultimately, owners will need to assemble information—usually referred to as a *data room*—that fully supports the story of historical and projected performance.

Thorough sell-side due diligence can help avoid a range of problems, including sellers' being blindsided by unanticipated issues, potential post-closing disputes, and simply failing to close the deal. Further, it can help realize a faster sale process by addressing issues early, and avoiding lengthy negotiations and disputes after closing. Ultimately, the appropriate positioning of the information gathered during the sell-side due diligence process often helps owners gain a higher sale price.

The data room

The data room typically brings together comprehensive information covering financial results, key business drivers, legal affairs, organizational structure, contracts, information systems, insurance coverage, environmental matters, and human resources issues. Information should start being pulled together as soon as the Confidential Information Memorandum has been drafted for distribution to prospective buyers.

The extent of information and level of detail in the data room should be balanced, providing enough information to enable buyers to determine a fair value but also limiting the amount of sensitive or competitive information disclosed to anyone other than the ultimate purchaser. Often, striking the right balance requires discussions between sellers and their advisors.

Today, data rooms are, increasingly, online information hubs that present the key information a buyer needs in order to begin judging value and underlying interest. Generally, online data rooms speed the process, lower costs, and better manage information flow by, among other things, differentiating access restrictions by buyer categories to block strategic ones from sensitive competitive information, while opening the same information to financial buyers.

Forming the team

Your internal team

During divestiture, owners face one of their most sensitive and critical tasks: determining their so-called circle of knowledge, or those key individuals at the company who need to know about the transaction.

For owners, the art lies in forming the right internal team. The correct people must be identified to gather information and interact with buyers. At the same time, the group must be narrow enough to control the consistency of the seller's message and minimize overall distraction from day-to-day operations. Generally, it's best to keep the group as small as possible—typically, 5 to 10 individuals. This considered, the circle may expand as the process progresses and as more internal leaders are needed to meet with buyers and demonstrate the depth of management.

Your external advisors

Given the limited bandwidth of a typical seller's resources, the nuances of the process, and the fact that the sale often represents a life-changing event for owners, experienced external advisors can be critical. Good advisors can smooth and accelerate the process while helping to accurately recognize value and provide insight and guidance in complex areas. Finally, the objectivity that advisors provide can be crucial to owners faced with many personally emotional, highly subjective decisions.

Moving toward negotiations and closing

With sell-side due diligence performed, the data room prepared, the offering memorandum sent out, and the team assembled, owners are ready to begin fielding questions from potential buyers and soliciting preliminary indications of interest and value.

The next installment in this series, *The Deal Process*, covers negotiating and getting to closing, avoiding pitfalls, and structuring the most efficient sale.

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